VAT CONSEQUENCIES OF DIGITISED PRODUCTS

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I hereby declare that I have read and understand the regulations governing the submission of Master of Philosophy dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

CONTENTS

1. INTRODUCTION

This article will look at whether the South African Value Added Tax Act (VAT) is up to the challenge of electronic commerce. The main question is 'can the South African Value Added Tax Act which is based on the physical economy, be flexible enough to embrace the virtual economy?' In order to answer this question, the VAT Act and the Organisation for Economic Corporation and Development (OECD) principles will be critically analysed. Since digitised products are intangible only "VAT services" provisions will be considered.

The discussion paper starts by giving a brief overview of e-commerce in part 2. This is followed by part 3, which stipulates the OECD's generally accepted e-commerce principles for consumption taxes such as VAT. Part 4 discusses the law and definition of concepts of VAT that may apply to digitised services. The last part discusses the application of the law to digitised products in the virtual e-commerce world.

2. E-COMMERCE: AN OVERVIEW

2.1 Definition

Westberg[1] defines electronic commerce as trade that uses computer, telecommunications networks or other automated media to facilitate transactions involving production, marketing, sale, delivery and distribution of goods and services.[2] Electronic commerce is made possible by the advent of the telecommunication by Alexander Graham Bell.[3]

2.2 Background

The world has increasingly become global, integrated and borderless with the coming of the internet.[4] The internet (which is the abbreviation for **inter**connected **net**works) is the most important network that electronic commerce uses. It refers to a system of

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[1] Westberg Bjorn, *Cross-Border Taxation of E-Commerce* (Netherlands: International Bureau of Fiscal Documentation) 2002 at 4.

[2] DM Davis "Residence-based taxation: Is it up to the challenge of e- commerce?" 2002*Acta Juridica* 161, available at < www.heineonline.uct.ac.za> at 162

[3] See Clive Sher, "Taxation of e-commerce" available at < www.butterworths.uct.ac.za>

[4] See Westberg Bjorn note 1 above at 2

thousands of logical connected computer networks globally, which facilitate data communication such as e-mail, file transfer and remote login.[5] The Internet was discovered in the mid 1960. It was developed to connect the United States of America defence force network called the Advanced Research Project Agency Network (ARPANET) to various radios and satellite network.[6] The internet, which started as a simple communication network for the few, has become technologically advanced for the conduction of business now referred to as electronic commerce.[7] Data, image, voice and video information can be transmitted on the internet at the speed of light on the information super highway.[8]

2.3 Significance

During the 1990's, the world witnessed a global explosion in electronic commerce involving trade in computer software; entertainment products such as videos and computer games; information services such as databases; and on-line financial and professional services.[9] The convenience, ease and variety of goods on the internet are the basis for the increased customer base. The internet also allows enterprises more access to consumers both domestically and globally.[10] As a result, there is an increased opportunity for international trade, not just for multinationals but also, for small and medium-sized enterprises that could not afford the costs of international expansion.[11] These advantages account in part for the proliferation of electronic commerce today.

2.4 Problems

E-commerce has affected consumption taxes such as VAT, Goods and Services Tax (GST) even more than direct taxes such as Income Tax. Actually, e-commerce has

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[5]Doernberg RL et al, *Electronic Commerce and Multijurisdictional Taxation* (Netherlands: Kluwer law international) 2001 at 22 See also Westberg B, note 1 above.

[6] See Doernberg RL et al, note 5 above at 10

[7] See Clive Sher, note 3 above

[8] Ibid.

[9] Ibid.

[10] Fang Michel, "International E-Commerce Source Taxation" 3 *Or. Rev. Int'l.* 104, 2001 at 104.

[11] See Clive Sher, note 3 above.

resulted in non-traditional market such as digitisation.[12] Digitisation is the process whereby the information is translated into a sequence of numbers called binary numerical form.[13] Digitisation changes what would normally be classified as goods to intangible products such as on line books.

It should be borne in mind that in every commercial transaction they are VAT consequences to be considered. Millions of electronic commerce transactions take place on the internet every minute with each transaction presenting a unique VAT consequence.[14] E-commerce has brought so many challenges both to the taxing authority, the taxpayer and the business environment. These challenges include: the risk of multiple taxation; the possibility of new or increased taxes; the risk of tax base erosion due to administrative and enforcement problems; the unfair competition and classification problems.[15]

One of the reasons for these challenges is that some of the traditional legislation cannot apply to electronic commerce transactions[16]. This is because these taxes were developed under the physical presence of goods and services within a jurisdiction.[17] These challenges are discussed below.

2.4.1 Challenges of e-commerce

Firstly, electronic commerce changes things of fundamental importance since it allows a foreign vendor to sell into another territory without physical presence.[18] This is made possible because it has created a whole range of new products such as digitised products (on-line books and software), and other on-line services that were

[12] RD de Swardt and R Oberholzer "Digitised Products: How compliant is the South African Value Added Tax?" *Meditari Accountancy Research Vol. No. 1 2006*:15-28.
[13] Ibid.
[14] See Fang M, note 10 above at 105.
[15] Buys CR, "The taxation of electronic commerce in South Africa" LLM thesis, UCT, 1998
[16] See Mclure CE Jnr, "Tax Competition in a digital world" 2003 International bureau of Fiscal Documentation
[17] See RD de Swardt and R Oberholzer note 12 above.
[18] See Clive Sher, note 3 above.

previously in form of tangible property.[19] E-commerce therefore, causes products' categorisation problems by disguising or changing the nature of products form goods to services.[20]

Goods and services classification problems are enhanced by lack of uniform international definitions of similar categories of supply.[21] The categorisation is important because different times of supply rules apply to goods and services. In addition the VAT treatment of imported goods and services also differ from local ones. Moreover, the taxing rights of the countries as well are determined by this classification.

Secondly, VAT has also been affected in the sense that it is uncertain whether the web based sale should be taxed or not. If these sales were taxable, in what jurisdiction should they be taxed? This also brings in a further problem as to what is the most effective way of collecting these taxes and ensuring fair tax compliance? E-commerce therefore, results in administrative and compliance problems.

It is the complexity of the network plus the ability to store and transmit high volumes of data around the world that presents many challenges to the tax authorities in the area of tax compliance and control.[22] It is difficult to identify the parties and jurisdictions involved in electronic commerce.[23] The new range of products and the way electronic commerce is conducted has made most of the traditional taxing norms to be revisited as they cannot apply to electronic commerce.

Thirdly, with the increased web-based sale, an increased number of transactions are made free of VAT when the buyer ignores the requirement to voluntarily pay taxes.

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[19] See Cockfield, "The Law and economics of Digital Taxation: Challenges to the traditional Tax Laws and principles" Queens University, Kingston Canada 2002. Available at International bureau of Fiscal documentation See Clive Sher, note 3 above.

[20] Ogutu W A and Van Der Merwe B, "Electronic Commerce: Challenging the Income Tax Base?" 17 *SA Merc LJ* (2005), at 312

[21] Ibid.

[22] See Westberg B, note 1 above.

[23] Ibid.

This could cause a strain on state revenues as it results in an erosion of a tax base for the country.[24]

Fourthly, e-commerce may lead to unfair competition if foreign-based companies are not taxed on their e-commerce sales[25]. This would affect the economy of the country as the people will be forced to be buying cheap foreign products as compared to the expensive local products.

Lastly, taxpayers not only face the risk of multiple taxation but also the possibility of new or increased taxes. E-commerce is international by nature and this may result in a double taxation by both the country of supply and the country of consumption. Even if there may be standard taxing rights rules for the countries to follow, the difficulty of collecting these taxes may force some countries to introduce new electronic commerce taxes.

However the Organisation for Economic Corporation and Development (OECD) has developed some principles to be followed on the imposition of consumption taxes on e-commerce. These principles are meant to provide fiscal climate in which e-commerce can grow while at the same time ensuring security of individual countries tax bases.[26] On average South Africa collects 25% of its revenue from VAT.[27] These are discussed below.

3 THE E-COMMERCE'S OECD GENERALLY ACCEPTED TAX PRINCIPLES

Due to the proliferation of e-commerce in the 90's, the OECD in 1998 agreed on a number of generally accepted tax principles that should apply to the taxation of e-commerce. These are sometimes referred to as Taxation framework Conditions. The reason for these principles is to eliminate conflict, distortions and disincentives to international trade. South Africa is not a member of the OECD but has an observer

[24] Charies G De Wet & Rainna du Plessis "Indirect Taxation-VAT" www.buys.co.za/publications/cyberlaw/cybertext/chapter9.htm Accessed on 11/09/2007
[25] See Mclure CE Jnr, note 16 above.
[26] See RD de Swardt and R Oberholzer note 12 above.
[27] See RD de Swardt and R Oberholzer note 12above.

status. Even though South Africa is not a member of the OECD, most of their Double Tax Treaties are based on the OECD Tax Model Convention.[28]

The first principle that the OECD agreed upon was that the tax provisions that apply to convectional commerce should also apply to e-commerce.[29] This principle eliminates the possibility of governments imposing a new tax on e-commerce which would result in discriminatory taxation against users of e-commerce. The imposition of new taxes would be against the tax neutrality principle. A good tax system has to achieve tax neutrality. A tax system is said to have achieved tax neutrality if it does not influence investment decisions of businessmen and women by favouring one set of investments over others.[30] This ensures that investors, both domestic and foreign, are not compelled by the tax system to invest in certain places or countries in order to attain a tax advantage.[31]

The second principle deals with classification of digitised products. The classification of digitised products for VAT purposes as goods or services is of fundamental importance. As already mentioned above, this is because the imposition of VAT may differ depending on whether the transaction is a supply of goods or supply of services.[32] The OECD has agreed that for consumption tax purposes, digitised products should not be classified as goods but services.[33] This means that under most tax systems the supply of digitised goods will be classified as supply of services.[34]

The third principle deals with taxing rights in order to avoid double consumption tax or unintentional non taxation on cross border e-commerce of digitised products. The OECD has agreed that taxation of such transactions should be taxed in the jurisdiction where consumption takes place.[35] In order to promote international consensus in

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[28] Olivier L et al, *International tax: A South African Perspective* (Cape Town: Siber ink) 2005 at 82
[29] Organisation for Economic Co-operation and Development (OECD) "Electronic commerce: Taxation Framework conditions, a report by the committee on fiscal affairs. October 1988a Paris
[30] See Cockfield AJ, note 19 above.
[31] Ibid, at 6
[32] See RD de Swardt and R Oberholzer note 12 above.
[33] Organisation for Economic Co-operation and Development (OECD) "Electronic commerce: Taxation Framework conditions, a report by the committee on fiscal affairs. October 1998a Paris
[34] RD de Swardt and R Oberholzer note 12 above.
[35] See OECD note 29 above

identifying the place of consumption the OECD defined the 'place of consumption' as follows:

The place of consumption for cross border supplies of services and intangible property that can be delivered from remote location for business to business (B2B) transactions is defined as a place where the recipient has a located business presence.[36] For business to consumer (B2C), the place of consumption is the jurisdiction where the customer has his or her usual place of residence.[37]

The business presence and place of usual abode points to the concept of resident. In this case it has been narrower than the resident concept used in South African VAT system.[38]

For B2B transactions, the recipient's business presence is the establishment to which the supply is made. This could be the recipient's headquarters, registered office or branch. In the case where the recipient has business presence in more than one jurisdiction, the place of consumption of a specific supply is the location of business presence to which the supply is made.

According to the OECD, B2C transactions recipient's business presence is not theoretically pure definition of the place of business. This is because it may not always result in taxation in the actual place of consumption. However, this definition is so far the most practicable option in e-commerce.

The fourth OECD principle involves the tax collections mechanisms. Most countries collect consumption taxes using methods such as supplier registration and reverse charge or self assessment. As a result, the OECD has come up with appropriate mechanisms which should apply to cross-border supply of digitised products.

In order to do this, the OECD has agreed that for B2B transactions, countries should apply a reverse charge or self assessment collection mechanism.[39] This method places

[36] See RD de Swardt and R Oberholzer note 12 at 19.
[37] Ibid.
[38] This concept has been discussed in detail in part 4.1 of this discussion paper.

the onus on the customer or consumer to asses the VAT payable on the product bought and pays to the tax authorities. It should be noted however, that the OECD[40] is aware that this method has got flaws for B2B transactions. It acknowledges that no single collection option for B2B transactions is without difficulties. Due to the difficulties with the reverse charge or self assessment, the OECD advises that governments apply a system of simplified registration for non-residents as a short term solution. However, on a longer term the OECD[41] advises that governments should develop computer software that would assist in collection of consumption taxes despite the fact that the complexity of the most consumption tax system is a constraint to such development of software. This would entail international consensus regarding classification of goods, remittance procedures, returns and harmonisation of tax rates for the development of the software to be successful.[42]

The third principle stated above has an extension which states that the supplier should be required to verify the VAT status of a customer with whom the supplier does not have an established relationship.[43] This verification includes a comparison of the customers VAT registration number on the customer's country database. This further entails that each country should endeavour to have the VAT registration numbers database in an on-line format for public use. The OECD[44] submits that each country should provide clear guidelines on what a supplier should do in the event that the customer's declaration does not correspond with the customers billing address and location at the time of the transaction.

The OECD has further recommended the use of the *geolocation software*, digital certificates and payment system information should be used to verify if it tarries with the customer's declaration.[45] *Geolocation software* aids to identify the location of the customer at the time of the transaction. This software makes use of the internet user's protocol (IP). It identifies the customer's location by comparing the destination IP

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[39] See OECD "Consumption tax aspects of electronic Commerce, A report from working party no.9 on consumption taxes to the commerce of fiscal affairs. 2001
[40] Ibid
[41] Ibid
[42] Ibid
[43] See OECD "Electronic Commerce-Verification of consumer status and jurisdiction: Consumption Tax Guide Series: Paper no. 3 Centre for Tax Policy and Administration. 2003d
[44] Ibid
[45] Ibid

user to a database of known IP numbers. According to OECD[46] statistics this software is between 85%-95% accurate. It is also recognised by the OECD that the current credit card information is able to assist in locating the jurisdiction of the customer to some extent.

4. THE LAW AND THE DEFINITION OF CONCEPTS

4.1 Value Added Tax Levying Provision

The South African VAT is governed by the VAT Act No. 89 of 1991.[47] This Act came into operation on the 30th of September 1991. Section 7(1) of the VAT Act is the charging provision. This section provides that VAT shall be levied on supply by any vendor of goods and services supplied by him on or after the commencement date in the course or furtherance of any **enterprise** carried on by him. It further provides that VAT shall be calculated at the rate of 14 per cent on the value of the supply.

Therefore, VAT is levied on the value of the supply of goods and services made by a vendor, in the course or in the furtherance of enterprise carried on by him. In general for VAT to be levied there is need to be a **supply** made by a **vendor** of either **goods** or **services**.

Supply is defined as 'including any performance in terms of a sale, rental agreement, instalment credit agreement and other forms of supply, whether voluntarily, compulsory or by operation of law, irrespective of where the supply is effected, and any derivative of supply will be construed accordingly'[48]

It is settled law in New Zealand that the word supply means the passing of possession of goods, pursuant to an agreement under which the supplier agrees to part with and the recipient to take possession. The New Zealand interpretation of the law is important because the South African VAT registration is copied from there.

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[46] Ibid
[47] Section 7(1) of the VAT Act
[48] Section 1 of the VAT Act

The word **Vendor**[49] is defined as 'any person who is or is required to be registered under the VAT Act in terms of s23 or 50A. Section 23 of the VAT Act requires any person who carries on an enterprise in which the total value of taxable supplies made by that person exceeds or will exceed R 300 000 in any twelve-month period to register as a vendor for VAT purposes. This section also provides for a voluntary registration in the case where the vendor's sells are less than R300 000 in a year but exceeds R20 000 a year. Section 50A is an anti-avoidance provision. It is there to combat schemes whereby a person whose income is above R300 000 threshold decide to split the business so that they do not have to register for VAT (since the threshold would be lower than R300 000) This provision deems such kinds of business to be one and requires the person to register for VAT.

Goods[50] are defined as any corporeal movable things, fixed property and any real right in any such thing or fixed property, but excluding; money, any right under mortgage bond and any stamp, form or card which has been sold or issued by the State for the payment of any tax levied by the Act of the Parliament, except when subsequent to its original sale or issue it is disposed of or imported as a collector's piece or investment article.

Services is defined as anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage but excluding items excluded in part (c) of the definition of "goods". I agree with De Koker and Kruger[51] that this definition is a catch all concept because it includes every thing that is not goods. It is submitted that in South African VAT system, digitised products fall under services because these products are not corporeal or real rights.

An **enterprise**[52] is generally defined as any activity that is carried on continuously or regularly by any person in South Africa or partly in South Africa and in the course or furtherance of which goods and services are supplied to any other person for a consideration whether or not for a profit.

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[49] Ibid
[50] Ibid
[51] De Koker and Kruger at Para 3.3
[52] Section 1 of the VAT Act

Therefore, if a person, whether a resident or not, carries on an activity in the Republic or at least partly in the Republic, in the course of which he makes available goods and services to any person at a consideration, such person will be required to levy VAT irrespective of where the goods and services are supplied.

Resident

The VAT act defines resident of the Republic as "a resident as defined in the Income Tax Act; provided that any other person or company shall be deemed to be a resident of the Republic to the extent that such a person or company carries on in the Republic any enterprise or other activity and has a fixed or permanent place in the Republic relating to such enterprise or other activity".[53]

It is submitted that the definition of resident in the VAT Act has got the same meaning as the Income Tax Act, except that the VAT Act has a deeming provision. This deeming provision provides that any company is deemed a resident of South Africa if it carries any activity or enterprise through a fixed place or permanent place in South Africa.

The Income Tax Act definition of a resident is in two phases: the first part deals with natural persons and the second part deals with non-natural or legal persons.[54] With respect to natural persons, a resident is a person who is "ordinarily resident" in South Africa or a person who passes the "physical presence test".[55] It has been suggested that these two tests are mutually exclusive. However, if a person is deemed to be a resident of the other country that is a party to the double taxation treaty, he or she is not included in the definition of resident.[56]

The term "ordinarily resident" is not defined in the Act. However, case law provides some useful insights into the meaning of this term. For example, in *Cohen's* case it was held that, ordinarily resident means the country to which one would naturally and

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[53] Section 1 of the VAT Act No. 89 of 1991
[54] Ibid.
[55] Huxham K and Haupt P "Notes On South African Income Tax" Hedron Tax Consulting and Publishing CC: Cape Town 2007 at 298
[56] D Koker and D Kruger *Value Added Tax In South Africa* (Butterworths : Durban 2006) Para 5.2A

as a matter of course return from his wonderings as contrasted with other lands.[57] It might be called his usual or principal residence and it would be described more aptly other than other country as his real home.[58]

In *CIR v Kuttel*,[59] it was held to mean where a person is habitually and normally resident apart from temporary or accessional absences of long or short duration. This decision confirmed the dictum in *Levene v IRC*,[60] where the term ordinarily resident connoted residence with some degree of continuity apart from accidental or temporary absences.

The physical presence test is an alternative test, which deems residence to occur with reference to the day-to-day counting rule.[61] This test only applies to natural persons who are not ordinarily resident in South Africa at any point during the year of assessment.[62] The person has to be physically present in South Africa in the current tax year for 91 days and for not less than 91 days in each of the previous five years of assessment. He must also have been physically present in the country for an aggregate of not less than 915 days in the said five years.[63]

In case of non-natural persons, the South African Income Tax Act defines a "resident" as a person incorporated, established, formed or which has its place of effective management in the Republic of South Africa.[64]

4.2 Imported Services and Levying Of VAT

Imported service is governed by section 14 of the VAT Act. The term **imported service** is defined in section 1 of the VAT Act as 'a supply of services made by a supplier who is non-resident or carries on business outside the South Africa to a recipient who is a **resident** of South Africa, to the extent that such services are used or consumed in South Africa otherwise than for the purposes of making taxable supplies.[65]

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[57] Ibid.
[58] *Cohen v CIR* (1945) 13 SATC 362 at 371
[59] 1992 (3) SA 242 (A), 54 SATC 298 at 305
[60] See *Levene v CIR* note 192
[61] See Huxham & Haupt note 55 above at 300; see also De Koker note 56 above at Para 5.2B
[62] See De Koker note 56 above at Para 5.2B
[63] Section (1) of the South African Income Tax Act No 58of 1962
[64] See section (1) of the South African Income Tax No 58 0f 1962
[65] See D Koker and D Kruger note 56 above at Para 8.10

According to the definition of imported service provided above, VAT is not payable on imported services meant to be used for the consumer's taxable supplies. However, it has been observed that SARS view that foreign companies which licence their intellectual property in South Africa are in essence conducting an enterprise in the Republic as such are supposed to register for VAT.[66] This has been argued as not effective in practice since it is difficult to police.[67] It is submitted that SARS view is in conflict with the concept of imported service. If a South African company is using the foreign trademark, the service in question does not constitute an 'imported service' for VAT purposes. This is because the service is used in the furtherance of taxable supplies and no VAT is leviable. SARS' aim may be to bring these exempt transactions into the levying provision.

VAT is payable where the imported services received by a person are utilised or consumed for private purposes or for the purpose of making exempt supply.[68] Therefore, any person who is not entitled to claim input tax in respect of services rendered by a non-resident will have to account for VAT on the imported service.[69] In terms of section 14 (5) imported service may not be chargeable to tax twice that is both under section 7(1) (a) and 7(1) (c) of the VAT Act.[70] If a supply of imported service is taxable under section 7(1)(c) or is zero rated in terms of section 11 or exempt in terms of section 12, no VAT will be leviable in terms of section 7(1)(c).

Specifically included in the exemptions of imported service is the provision of imported educational services by an educational institution outside South Africa regulated by an education authority outside South Africa. The provision of services by employees who receive remuneration is also excluded from the definition of imported service.[71]

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[66] Ibid.
[67] Ibid.
[68] See Charlie de Wet and Riana du plessis note 24 above at 261
[69] Ibid.
[70] See De Koker and Kruger note 56 above at Para 8.10
[71] See section 14(5)(c) and 14(5)(d) of the VAT Act.

VAT on imported services is collected using either reverse charge mechanism or normal registration.[72] As already mentioned, reverse charge mechanism means that the onus is on the recipient of imported service to account for VAT. The recipient or consumer of the imported service is required to furnish the Commissioner with a declaration and pay the tax within 30days of the issue of the invoice by the foreign supplier.[73] However, if the foreign supplier is considered to be conducting an enterprise, the VAT Act places the obligation on him to register in order to levy VAT from the consumers and remit to SARS.

In terms of section 14 (3), the value of the imported service is the greater of the value of consideration or the open market value of the supply.

The imported service provision contains a specific anti-avoidance provision which is aimed at preventing the avoidance of VAT. For example, if the same legal entity carries on an enterprise in South Africa but also performs services unrelated to the South African enterprise outside South Africa the services provided to the South African enterprise for the furtherance of non-South Africa activities are not taxable under normal rules. [74] The above services do not constitute **supply** because they are supplied to the same legal person. Supply requires the involvement of two separate legal persons. The anti-avoidance provision deems such types of services to be an imported service if the service had been supplied directly by the Foreign Service provider would constitute an imported service.[75]

The aim of imposing VAT on imported service is to prevent unfair competition. The result is that businesses making taxable supplies in South Africa are not subject to VAT on imported services according to definition provided above.[76] The reason is; even if they were to acquire these services locally, they would be entitled to an input tax credit for the VAT paid by them. According to De Koker and Kruger[77], the unfair competition aim of this provision is also achieved to persons making exempt supplies.

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[72] See Charlie de Wet and Riana du plessis note 24 above at 261
[73] The VAT Act section 14 (1), and 14 (2) read together with section 7 (2).
[74] See De Koker and Kruger note 56 above at Para 8.10
[75] See The VAT Act section 14 (4)
[76] See DeKoker & D Kruger see note 56 above
[77] See DeKoker & D Kruger see note 56 above

This is because imported service is taxed in the hands of these people and the local VAT is also not claimable.

4.3 Exported Services and Levying Of VAT

In the South African VAT system, taxable supplies will either be zero rated or standard rated. Zero rated means that they are taxed at a rate of zero percent. Standard rated supplies are taxed at the rate of 14%. Most exports are zero rated provided they meet the requirements of section 11 of the VAT act. This part will discuss some of the zero rating provisions that may apply to digitised products.

Firstly, services physically supplied outside South Africa are Zero rated in terms of section 11(2) (k) of the VAT Act. For example, a supply of the South African lawyer of professional advice while visiting a client in Australia.[78] Therefore, services supplied directly to a non-resident who is in South Africa at the time the services are rendered will not be zero rated unless the supply of services in question form part of a supply to a South African vendor by the non-resident.[79]

Secondly, the zero rating also applies where services that are supplied to a non-resident who is outside South Africa at the time the services are rendered.[80] However, the services will not be zero rated if supplied directly in connection with land or improvements to land situated in South Africa or are supplied in connection with movable property situated in South Africa. The latter prohibition will not operate if the movable property is exported to the customer after the services or if the movable property forms part of a supply by the non-resident to a South African vendor and the services in question are supplied to the non-resident for purposes of the supply in question.[81]

Thirdly, supply of services relating to intellectual property rights are also zero rated if they are for the use outside South Africa.[82] The services in relation to intellectual property include filling, prosecution, granting, maintenance, transfer, assignment,

[78] See DeKoker & D Kruger see note 56 above
[79] See DeKoker & D Kruger see note 56 above at Para 5.29
[80] See The VAT Act section 11 (2)(*l*)
[81] Ibid
[82] The VAT Act section 11(2)(m)

licensing or enforcement of intellectual property rights and the incidental supply of any other services that are necessary for such services.[83]

Lastly, in terms of section 11(2)(o) of the Vat Act read together with section 8 (9) of the same Act, a vendor who supplies taxable services to a branch or main business of his enterprise situated outside South Africa will be zero rated if it is separately identifiable and an independent accounting system is maintained. However, the services will not be zero rated if supplied in the following circumstances: firstly, if services are supplied directly in connection with land or improvements to land situated in South Africa; secondly, if the main business or branch is in the country at the time services are rendered; and lastly, if services are supplied in connection with movable property situated in South Africa. The last prohibition will not operate if the movable property is exported to the customer after the services or if the movable property forms part of a supply by the non-resident to a South African vendor and the services are supplied to the non-resident for purposes of the supply in question.

5. DISCUSSION

The South African VAT System has adopted most of the OECD's principles in its act. For example, it applies convectional tax principles to e-commerce. In other words, the VAT act does not contain any special rules for the e-commerce. This is consistent with the OECD's principles. Secondly, it has a vendor search facility on SARS website to enable suppliers to verify the customer's status. However, there are no rules to be followed in the event that the information declared by the consumer differs with one on the data base. Furthermore, there are complaints that this VAT vendor search facility does not work very well.

Having said that, a discussion on whether the South African VAT system meets the challenges of e-commerce is ensued. The discussion is divided into two divided into two parts. The first part discusses registration and VAT consequences of imported digitised products. The second part discusses the VAT treatment of exported digitised products.

[83] Ibid

5.1 Registration of Foreign Supplier and Imported Service VAT Consequences.

The South African VAT system is a destination based.[84] This means that goods or services are taxed where the consumer is situated.[85] This implies that VAT will be levied if the consumer is located in South Africa and will not be levied on exported supplies because the consumer is located outside South Africa. This approach corresponds with the OECD that states that e-commerce supplies should be taxed in the jurisdiction where the consumer is located.

According to the OECD, the destination-based approach of VAT system normally relies on proxies which determine whether consumption is considered to take place outside the country or not. The South African VAT system unlike other VAT systems has got an unusual feature in that it lacks "the place of supply rules" These rules help to determine whether a particular supply is subject to VAT in a particular country or not.[86] Despite this unusual feature, the definition of an enterprise in section 1 of the VAT Act read together with the VAT export and import rules are used to determine whether or not consumption of a supply has taken place in South Africa or not.[87]

In terms of section 7(1) (a) VAT is chargeable on a supply made by a vendor who is carrying on an enterprise in South Africa. The supply should be made in the course or furtherance of the vendor's enterprise. The enterprise definition in section 1 of the VAT Act requires that an activity to be carried on regularly or continuously in or partly in South Africa. However, there is no clear indication as to when a person is conducting an enterprise in South Africa and what requirements of a South African operation must be particularly in relation to a foreign business before the South African business is considered to apply.[88] Therefore, it is uncertain for a foreign supplier who supplies digitised services in South Africa to know whether he is under obligation to register as South African VAT vendor or not.[89]

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[84] See DeKoker & D Kruger see note 56 above at Para 1.4
[85] See RD de Swardt and R Oberholzer note 12 above at 20
[86] Ibid at 20
[87] Ibid
[88] See Charlie de Wet and Riana du plessis note 24 above at 263.
[89] Ibid See also de Swardt and R Oberholzer note 12 above at 20

The South African VAT on imported service is collected either directly from the foreign supplier if he registers as VAT vendor in terms of section 23[90] or from the consumer in terms of section 7(2)[91] of the same Act. The vendor registration collection method can only be used if the foreign supplier of digitised goods is considered to be conducting an enterprise in South Africa. The self-assessment method is used if the foreign supplier is considered not to be carrying on an enterprise in South Africa. If this is the case the foreign supplier is not obliged to charge VAT and the consumer is obliged to self asses the amount of VAT due and remit it to SARS.[92] The self-assessment method will only be applied if the consumer is resident in South Africa and has consumed the products in South Africa.[93]

Therefore, this collection method requires the foreign supplier to know the status of the consumer. The foreign supplier has to determine the residence status of the consumer and this depends on whether the transaction is a B2C or B2B. For B2C transaction, the foreign supplier has to determine whether the customer is ordinarily resident in South Africa or is a resident through the physical presence test.[94] In case of B2B transaction, the foreign supplier has to determine whether a particular customer carries on an enterprise or any other activity in South Africa and has a fixed or permanent place of business in South Africa in connection with such an enterprise. This criterion is similar to the OECD business presence test in determining the place of consumption. Checking the status of the consumer may be difficult for the foreign supplier.

According to De Swardt and R Oberholzer[95], the current uncertainty of the foreign supplier of digitised products to residents of South Africa as to whether he is carrying an enterprise in South Africa or not will affect the foreign supplier's obligation to impose VAT on those supplies. It is also submitted that apart from this problem, the supplier will also have difficulties to know the residency of the customers especially on e-commerce.

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[90] This section stipulates the requirements of registration for VAT purposes i.e. R300 000 threshold for compulsory registration and R20 000 for voluntary registration. This provision has been discussed on part 4.1 of this paper.
[91] This section provides that the recipient of the imported service ha the obligation to pay VAT
[92] See de Swardt and R Oberholzer note 12 above at 23
[93] See de Swardt and R Oberholzer note 12 above at 23
[94] This test has been explained in Page 13 of this discussion paper.
[95] See de Swardt and R Oberholzer note 12 above at 24

According to a survey[96] carried by De Swardt and R Oberholzer 50% of the respondents thought that a foreigner who supplies digitised electronic products to recipients in South Africa is carrying on an enterprise. This is because the regularity and continuity in the definition of an enterprise do not relate to jurisdiction but to the enterprise. 75% of the respondents thought that if the server, on which the foreign supplier's website is hosted, is located in South Africa, the foreign supplier is carrying on an enterprise in South Africa. They further thought that it does not matter if the server is owned by somebody else. More than 90% of the respondents agreed that if the foreign supplier has a business presence such as a branch with an office operating a call centre in South Africa, he is also regarded as carrying on an enterprise.

From the above discussion it is evident that most e-commerce digitised products generally constitute carrying on of an enterprise in South Africa but due to lack of certainty in the definition of an enterprise as to what operation would constitute the carrying on of an enterprise in South Africa makes it more problematic for e-commerce of digitised products. This problem has been described as major deficiency of the South African VAT system with regard to taxation of digitised products.[97] This is because the foreign supplier has to make real time decision as to whether VAT should be imposed on the supply made to the person in South Africa. Due to lack of clarity on whether the foreign supply of digitised products is conducting an enterprise in South Africa will not be able to make the correct decision.

However, section 23[98] of the VAT Act implies that it was the intention of the South African legislature to regard a foreign supplier that supplies digitised products to person located in South Africa as carrying on an enterprise in South Africa. Unfortunately the section does not make any distinction between registration procedures for foreign suppliers and local suppliers.[99] This is in conflict with the OECD principle that states that foreigners should have simplified registration.

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[96] This survey was conducted to find out whether there any discrepancies between the OECD principles and the South African VAT Act. The respondents were tax practitioners and VAT specialists.
[97] See de Swardt and R Oberholzer note 12 above at 20
[98] This section stipulates the requirements of registration for VAT purposes i.e. R300 000 threshold for compulsory registration and R20 000 for voluntary registration. This provision has been discussed on part 4.1of this paper.
[99] De Swardt and R Oberholzer note 12 above at 23

On the other hand, section 7(2) places the onus to charge and remit VAT on imported service on the recipient (self assessment or reverse charge provision). This implies that somehow that it was not the intention of the South African legislature to regard a foreign supplier that supplies digitised products to person located in South Africa to be regarded as carrying on an enterprise in South Africa. The self-assessment collection mechanism is consistent with the OECD principles despite the fact that it is said to be the least effective method by the OECD.[100] Due to the method's inefficiency the OECD recommends the use of a simplified registration for foreign suppliers as a short term measure. As a long term measure the OECD recommends the development of computer software such as *geo-location software* which would aid with collection procedures. The South African VAT system does not have simplified registration for foreign suppliers nor has it developed software. It is submitted that in this regard South African VAT system is inconsistent with the OECD generally accepted e-commerce principles.

It is also submitted that the suggestions by the OECD are not only complex and expensive but also ideal. For example until now no country has been successful in using or developing the *geolocation software*. The only solution that seems to be tangible is the provision of simplified registration for foreign suppliers and the use of credit card information.

It is further submitted that the imposition of VAT on somebody who is not a VAT vendor is alright but for such a person to operate the VAT correctly is unthinkable.

5.2 VAT Consequences Exported Digitised products

As mentioned earlier, where a supplier is conducting an enterprise in South Africa, he or she is obliged to charge VAT on the supply of digitised services. However, such supplies are zero rated if they are physically supplied outside South Africa or to a non-resident in terms of section 11(2) (*k*) and 11(2) (*l*) of the VAT Act respectively.

This implies that the resident supplier of digitised products has to know whether the customer is a resident of South Africa or not. This task is complex and difficult, if not impossible to apply to e-commerce.[101] In case of a legal entity, the supplier has to

[100] See de Swardt and R Oberholzer note 12 above at 24
[101] See de Swardt and R Oberholzer note 12 above at 21

determine whether a particular customer carries on an enterprise or any other activity in South Africa and has a fixed or permanent place of business in South Africa in connection with such an enterprise. In case of a natural person, the supplier has to determine whether the customer is ordinarily resident in South Africa or a resident through the physical presence test.[102]

The onus is on the supplier to prove that the requirements of section 11(2) (*l*) of the South African VAT Act are complied with (*South African Rugby Football Union v CSARS.*[103] The VAT Act is silent as to the process that the supplier must follow to verify that the customer is not a resident of South Africa and is outside South Africa at the time of the transaction.[104]

In e-commerce world, it would be difficult for the supplier to prove that the consumer is not in South Africa at the time when digitised products are supplied. Moreover, it is difficult to identify the parties and jurisdiction involved in e-commerce. Secondly the place of residence outside South Africa is not conclusive evidence that the digitised services are consumed outside the country. Lastly, it would be difficult for the supplier to prove that the customer is not a resident of South Africa.[105]

6. CONCLUSION

This paper has shown that the advent of e-commerce has resulted in numerous problems both for the taxpayer and the taxing authority. Most countries use guide lines set up by the OECD in trying to overcome these e-commerce problems. The South African VAT system has most of these principles in place.

However, even though the South African VAT system has got most of the OECD e-commerce principles, it is very inadequate in dealing with e-commerce transactions. This is because the OECD principles themselves are also not very competent to deal with the e-commerce problems. For example, even if one uses the *geo-location* software proposed by the OECD, determining the residence of the parties in e-commerce transaction will always be problematic.

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[102] This test has been explained in Para 4.2 above
[103] 61 SATC 406
[104] See de Swardt and R Oberholzer note 12 above at 22
[105] See de Swardt and R Oberholzer note 12 above at 25

The paper has also shown that the South African VAT system is inconsistent with the OECD to the extent that it lacks the specific rules such as "the place of supply rules" and "simplified registration for foreign suppliers" It is submitted that this defeats the purpose of the law and as such there is still a potential for the erosion of the South African VAT base. The South African VAT system is therefore hardly e-commerce compliant. Most e-commerce transactions are not caught by the South African VAT system.

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