

**INTERNATIONAL TAXATION & DOMESTIC  
TAXATION: DETERMINING 'SOURCE' WITHIN  
AND OUT OF AN E-COMMERCE  
ENVIRONMENT**

[DISSERTATION ONE OF TWO]

**&**

**VAT IMPLICATIONS IN E-COMMERCE FROM  
A SOUTH AFRICAN PERSPECTIVE**

[DISSERTATION TWO OF TWO]

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Course Code: CML 6053W  
Hand-in: February 2009

Research dissertation presented for the approval of Senate in fulfilment of part of the requirements for the Masters of Philosophy in Commercial Law in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

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

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## PREFACE

This paper deals with the relationship between domestic tax laws and double tax treaties with respect to transactions occurring in an E-commerce environment. In order to understand the taxing consequences arising from an E-commerce transaction, the taxing consequences of international transactions outside of an E-commerce environment must also be examined and explored. Furthermore, this paper is primarily concerned with determining the “source” of income arising from international transactions and, more specifically, E-commerce transactions. As such, both domestic legislation and case will be examined in conjunction with double tax treaties and Commentary published by the Organisation for Economic Co-operation and Development. The international community’s position on the matter will be examined in conjunction with a brief overview of suggested solutions and problems arising and facing the international community in relation to the phenomenon that is the Internet.

JANUARY 2009  
ANNE M BARDOPOULOS

INTERNATIONAL TAXATION & DOMESTIC TAXATION: DETERMINING  
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## CHAPTER ONE

### INTRODUCTION<sup>A</sup>

Plato stated that “*when there is an income tax, the just man will pay more and the unjust less on the same amount of income*”.<sup>1</sup> Plato’s “just”, by virtue of having paid their taxes, qualify for that euphoric experience of “intoxication”, that is, the “*Euphoria at getting a tax refund, which lasts until you realize it was your money to start with.*”<sup>2</sup> With the introduction of the Internet<sup>3</sup> and E-Commerce<sup>4</sup>, nations, governments and taxpayers have encountered a new arising problem of determining which State is entitled to this tax and from which State taxpayers may claim their ‘tax refunds’, if at all!

### The History of Taxation

The history of taxation dates all the way back to the Ancient Egyptians. The practice of taxation was then followed by Ancient Greece. The Ancient Greeks imposed various forms of taxation, including a special tax during times of

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<sup>A</sup> Anne Bardopoulos et al *International Taxation & Domestic Taxation: Tax Avoidance and Double Tax Agreements. The increasing need for International Tax with increasing Globalization. How International Tax Treaties affects Domestic Income Tax laws, within the context of tax avoidance, and vice versa* University of Cape Town Higher Diploma in Taxation (2007) Introduction, 5-8

<sup>1</sup> Plato 428BC – 348BC. Available at <http://www.quotesandpoem.com/quotes/listquotes/subject/taxes> [Accessed 22 January 2007]

<sup>2</sup> Anonymous. Available at <http://www.taxworld.org/quotes.htm> [Accessed 24 November 2006]

<sup>3</sup> Refer to Chapter Two of this paper regarding the “Internet”. For further brief information, refer to TechTarget, available at [http://searchwindevelopment.techtarget.com/sDefinition/0,,sid8\\_gci212370.00.html](http://searchwindevelopment.techtarget.com/sDefinition/0,,sid8_gci212370.00.html) [Accessed 17 June 2008]

<sup>4</sup> “E-commerce (electronic commerce or EC) is the buying and selling of goods and services on the Internet, especially the World Wide Web. In practice, this term and a newer term, e-business, are often used interchangeably. For online retail selling, the term e-tailing is sometimes used. E-commerce can be divided into:

- E-tailing or “virtual storefronts” on Web sites with on-line catalogs, sometimes gathered into a “virtual mall”.
- The gathering and use of demographic data through Web contacts.
- Electronic Data Interchange (EDI), the business-to-business exchange of data
- Email and fax and their use as media for reaching prospects and established customers (for example, with newsletters)
- Business-to-business buying and selling
- The security of business transactions”

As defined by TechTarget, available at

[http://searchcio.techtarget.com/sDefinition/0,,sid182\\_gci212029.00.html](http://searchcio.techtarget.com/sDefinition/0,,sid182_gci212029.00.html) [Accessed 17 June 2008]

war. The Ancient Greeks were one of the first and few 'societies that were able to rescind the tax' after the emergency or war was over.<sup>5</sup>

Taxation is 'a compulsory levy made by public authorities for which nothing is received directly in return.'<sup>6</sup> This 'compulsory levy' is, however, "a common phenomenon of human society"<sup>7</sup>. The oldest taxation records were unearthed with the discovery of King Scorpion the First's tomb. The discovery of these first tax records was not only significant for the history of taxation, but also for written language. These unearthed tax records have the "oldest use of writing with symbols representing constants and forming syllables - hieroglyphics"<sup>8</sup>. "As the archaeologist, Gunter Dreyer, who discovered the Scorpion I tomb observed, writing emerged as an innovation because of economic necessity rather than from creative expressions of mankind"<sup>9</sup>. This 'economic necessity' appears to have been the collection of taxation. Thus, it may be debated that the collection of taxes was a major component in the development of writing!<sup>10</sup>

### What Exactly is Taxation?

As previously quoted, taxation is 'a compulsory levy made by public authorities for which nothing is received directly in return'<sup>11</sup>. In present times, governments generally collect taxes. Taxes are a payment, a financial charge, imposed by the government to raise funds for direct and indirect provisions. Otherwise referred to as 'direct taxes' and 'indirect taxes', the former is generally raised for the provisions, maintenance and running of the public sector and the latter is associated with "benefit [which the taxpayers] gain from their link with that country".<sup>12</sup>

Throughout the history of taxation, the collection of taxes has been a form and method for the government to raise money and funds from the people or citizens of that country. And in the words of Franklin D Roosevelt, "taxes, after

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<sup>5</sup> TaxWorld 'A History of Taxation. Available at <http://www.taxworld.org/History/TaxHistory.htm> [Accessed 24 November 2006]

<sup>6</sup> *ibid* 2

<sup>7</sup> *ibid* 22

<sup>8</sup> *ibid*

<sup>9</sup> *ibid*

<sup>10</sup> *ibid*

<sup>11</sup> *ibid*, *The International Taxation System* 2

<sup>12</sup> *ibid*

*all, are the dues that we pay for the privileges of membership in an organized society*”<sup>13</sup>.

### **What is Globalization?**

Globalization, first defined by Roland Robertson of the University of Pittsburgh, is “*the compression of the world and the intensification of the consciousness of the world as a whole*”<sup>14</sup>.

Alexander the Great may have first conceived the idea and vision of Globalization. As Alexander the Great conquered foreign lands, the ideology behind the pursuing peace was for easier and increased trade between all conquered lands, and Greece. Although Alexander the Great was known for allowing the rulers of the conquered lands to remain in power, his dream was to unite the world under one economic state. However, due to his early death, the concept of Globalization was neither fully explored nor implemented.

Actual implementation of Globalization has been recorded as existing during the Mongolian Empire (1206 – 1368)<sup>15</sup>. However, the 19<sup>th</sup> Century Liberalization is often referred to as the “THE FIRST ERA OF GLOBALIZATION”.<sup>16</sup>

The “FIRST ERA OF GLOBALIZATION” broke down with World War One, followed by the ‘Gold Standard Crisis’.<sup>17</sup> Despite these set-backs, Globalization could not be stopped, and since World War II Globalization “...in turn, has been driven importantly by advances in technology. By lowering the costs of gathering information and conducting transactions, new technologies have reduced market frictions and provided significant impetus to the process of broadening world markets”.<sup>18</sup> In short, Globalization may be “viewed as a centuries long process,

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<sup>13</sup> Franklin D Roosevelt. Available at <http://thinkexist.com/search/searchquotation.asp?search=tax&page3> [Accessed 8 May 2008].

<sup>14</sup> Professor Michael Mainelli of the Gresham College. Available at <http://www.gresham.ac.uk/printtranscript.asp?EventId=514> [Accessed 17 June 2008]

<sup>15</sup> *Timeline of the Mongolian Empire, The Mongolian Empire: A Historical Website*. Available at <http://www.geocities.com/Athens/Forum/2532/> [Accessed 5 January 2009]

<sup>16</sup> Brink Lindsey et al *The Decline and Fall of the First Global Economy, How nationalism, protectionism, and collectivism spawned a century of dictatorship and war*. Available at <http://www.reason.com/news/show/28241.htm> [Accessed 17 June 2008]

<sup>17</sup> *ibid*

<sup>18</sup> Alan Greenspan et al *Testimony of Chairman Alan Greenspan, Trade Policy Before the Committee on Finance, U.S. Senate*. April 4, 2001.

Available at <http://www.federalreserve.gov/boarddocs/testimony/2001/200104042/default.htm> [Accessed 17 June 2008]

*tracking the expansion of human population and the growth of civilization, that has accelerated dramatically in the past 50 years”<sup>19</sup>.*

Globalization, with regards to taxation, has resulted in international critical policy changes as the “*pressure for tax rate convergence gravitating towards lower rates*” mounts<sup>20</sup>, otherwise referred to as ‘tax competition’. This ‘tax competition’ has resulted in the reduction of domestic “*governments’ ability to raise [national] revenue through taxes*”<sup>21</sup>. The primary reason for this reduction is due to the increased labour and capital mobility which has made it easier to destroy the tax base of governments’ around the world.<sup>22</sup>

### **The Development of International Taxation**

International taxation developed, and was derived, from International Trading. Dating back to the Ancient Greeks, countries found ways to prosper through International Trading, that is, trading with other countries. In fact, it has been debated that business superpowers of the past thrived, grew and existed as a result of their extensive and well established International Trading.<sup>23</sup> The Ancient Greeks, followed by the Romans and the Byzantine Empire, protected their trading, and thus ensured trading growth, through the utilization of their armies to protect trading routes and merchants.<sup>24</sup>

International Trading has evolved into one of the aspects of modern day ‘Globalization’. A further sub-category of modern ‘Globalization’ is the Internet and e-Commerce. For the purposes of this paper, ‘Globalization’ will be examined within the context of International Trade occurring within and out of e-Commerce and the Internet.

International Trade, especially with the development of International Trade within e-Commerce and the Internet, has resulted in questions arising, such as: ‘*Who is entitled to the taxation on such trading? And how is ‘source’ defined and determined for purposes of determining taxation rights?*’

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<sup>19</sup> The Financial Express. Available at <http://www.financialexpress.com/news/No-boundaries/245732/> [Accessed 17 June 2008]

<sup>20</sup> Nicoli Nattrass et al *Macroeconomics Theory and Policy in South Africa* 3ed Revised (2003) 309

<sup>21</sup> *ibid*

<sup>22</sup> *ibid*

<sup>23</sup> *ibid*, *The International Taxation System* 44

<sup>24</sup> *ibid*

In determining these 'taxation rights' the concept and principles behind "International Taxation" will also be explored and examined within this paper. International Taxation, briefly put, is the '*international aspects of domestic laws*'.<sup>25</sup> In other words, 'international tax' is a subject of study that deals with international tax treaties and international aspects of domestic income tax laws. No International Tax Laws, per se, actually exist. However, when countries enter into double tax treaties, these treaties come the closest to being International Law. The reason such treaties only 'come close' to International Law, and are not in fact International Law, is because only the 'Contracting States'<sup>26</sup> are obliged to follow these Treaties.<sup>27</sup> Thus, to understand International Taxation one must understand the interaction between the two 'Contracting States' tax systems.<sup>28</sup>

The 20<sup>th</sup> Century has seen the development of various organisations as a result of 'globalization'. Model Tax Conventions are usually used when entering into and establishing a Double Tax Agreement between two States. Various organisations have issued their own Model Tax Conventions, of which the three most commonly known and used Model Tax Conventions are the United Nations (hereinafter referred to as UN), the Organization for European Economic Co-Operation (hereinafter referred to as OECD) and the United States of America Draft Model Income Tax Convention.

The United States of America (hereinafter referred to as USA) have published their own Model Convention which they use to negotiate USA treaties. While the USA Model Convention is based on the OECD Model Convention, it includes specific USA policy concerns. Most countries, as a rule, do not have their own Model Conventions, ensuring better global unification with regards to globalization and international taxation as they all negotiate their treaties based on the UN or OECD Model Convention. Thus, the USA appear to be in the minority with regards to having published and to using their own Model Convention,

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<sup>25</sup> Lynette Olivier & Michael Honiball et el *International Tax, A South African Perspective 2008, Fourth Edition* (2008) 1

<sup>26</sup> 'States', as used within the OECD Model Convention, refers to 'countries'.

<sup>27</sup> Lynette Olivier and Michael Honiball et el *International Tax A South African Perspective 2005 3ed* (2005)

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<sup>28</sup> *ibid*

reminding us, in turn, of Winston Churchill's words: "*Americans always try to do the right thing after they've tried everything else*"<sup>29, 30</sup>

The UN Model Tax Convention is aimed at serving the interests of developing countries. While the UN Model Tax convention structure corresponds to that of the OECD Model Convention the content, on the other hand, of the UN Model Convention is contradictory with regards to some important aspects. The UN Model Convention has developed into an important Model for negotiations between developed and developing countries due to the fact that it is aimed at benefiting the developing countries.<sup>31</sup>

OEEC, initially formed in order to administer Canadian and United States of American aid after World War II for the reconstruction of Europe, encouraged free trade between member States in a growing 'globalizing' world. The OECD took over from the OEEC in 1961. The OECD is "*looking ahead to a post-industrial age in which it aims to tightly weave OECD economies into a yet more prosperous and increasingly knowledge-based world economy*"<sup>32</sup>. It may be argued that the creation of, first, the OEEC and then the OECD was a necessity due to globalization. The OECD offers a platform to member States to work together and, furthermore, to address issues such as "*economic, social and governance challenges of globalization*"<sup>33</sup>. Within the context of this paper, the OECD sets the opportunities for negotiations on taxation and transfer pricing, and has "*paved the way for bilateral tax treaties around the world*"<sup>34</sup>, and now even multilateral treaties. The OECD, created and developed as a result of 'globalization', promotes international co-operation in taxation between member States. In order to assist with this 'co-operation' the OECD has published a 'Model Convention for the Avoidance of Double Taxation of Income and Capital'.<sup>35</sup> (For purposes of this paper, only the OECD Model Convention shall be examined.)

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<sup>29</sup> Winston Churchill. Available at <http://www.quotegarden.com/america.html> [Accessed 27/06/2008]

<sup>30</sup> *ibid*, Klaus Vogel on Double Tax Conventions, 10

<sup>31</sup> Klaus Vogel, *Klaus Vogel on Double Tax Conventions* (1991) 10

<sup>32</sup> OECD et al *Overview of the OECD: What is it? History? Who does what? Structure of the organisation?* Available at [http://www.oecd.org/document/18/0,3343,en\\_2649\\_201185\\_2068050\\_1\\_1\\_1\\_1.00.html](http://www.oecd.org/document/18/0,3343,en_2649_201185_2068050_1_1_1_1.00.html) [Accessed 5 January 2009]

<sup>33</sup> *ibid*

<sup>34</sup> *ibid*

<sup>35</sup> OECD. Available at

[http://www.oecd.org/documentprint/0,2744,3n\\_2649\\_201185\\_2068050\\_1\\_1\\_1\\_1.000.html](http://www.oecd.org/documentprint/0,2744,3n_2649_201185_2068050_1_1_1_1.000.html)

It may be noted that due to access of information on hand in preparing this paper, it may read more from a South African perspective in determining the definition of “source” in an E-commerce environment and the taxation implications thereof. While this may be the case, it should be noted that while South Africa is not currently a member of the OECD, South Africa does, nevertheless, follow the OECD Model Tax Convention for purposes of Double Tax Agreements. Furthermore, as per *Secretary for Inland Revenue v Downing* case<sup>36</sup>, South African courts have also accepted the use of OECD Commentary for interpreting tax treaties. It may be found that basic tax principles set out in South African courts do not actually differ from most other OECD member States, but rather definitions, inclusions and exclusions may differ. Thus, the predominant use of South African tax cases, utilised to set out and illustrate a principle, should not deter from the application of such principles in an international context (remembering that ‘International Taxation’ is merely ‘*international aspects of domestic laws*’<sup>37</sup>).

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[http://www.oecd.org/documentprint/0,2744,en\\_2649\\_201185\\_1876671\\_1\\_1\\_1\\_1.000.html](http://www.oecd.org/documentprint/0,2744,en_2649_201185_1876671_1_1_1_1.000.html)  
[http://www.oecd.org/documentprint/0,2337,en\\_2649\\_201185\\_1\\_1\\_1\\_1\\_1.000.html](http://www.oecd.org/documentprint/0,2337,en_2649_201185_1_1_1_1_1.000.html) [Accessed 24 January 2007]

<sup>36</sup> *Secretary for Inland Revenue v Downing* 37 SATC 249 (hereinafter the “Downing case”).

A brief summary of the Downing case is as follows:

Downing lived in South Africa, after which he emigrated to, and became a resident of, Switzerland. Due to South African Exchange Control regulations Downing was not allowed to remove all his money and, as a result, left a large portfolio of shares in South Africa. Downing appointed Smith to look after and deal in his shares and to manage his portfolio. The South African Revenues Services (hereinafter “SARS”) stated that there was a permanent establishment in South Africa, due to the use of an ‘agent’ (Smith), and as such taxed the profits arising from the portfolio. However, if Downing could prove that there was no permanent establishment then SARS would not be able to tax him as only his resident county would have such a right in terms of the Double Tax Agreement between South Africa and Switzerland. This case laid down authority for courts to use the OECD Commentary as guidelines.

<sup>37</sup> Lynette Olivier & Michael Honiball et al *International Tax, A South African Perspective 2008, Fourth Edition* (2008) 1

## CHAPTER TWO

### INTERNET, WEB SITES AND INTERNET SERVICE PROVIDERS

Contained within this chapter a brief, simplified explanation of the Internet, a Web site and an Internet Service Provider (hereinafter referred to as ISP) is offered. The definition and explanations provided are limited and included purely for a brief oversight and understanding of what the Internet and its components are and how they work.

#### Internet

The Advanced Research Project Agency (hereinafter referred to as ARPA), created and established as the USA's response to the Soviet Union's launch of the first satellite, Sputnik I, was aimed at regaining the USA's technological lead in the 'arm's race'. As such, ARPA sought out computer scientists throughout the USA to research 'networks'. As scientists from various institutes increasingly joined the research team, there was a request for additional 'computers' from the ARPA to aid in this research. In order to limit the number of computers the ARPA was requested to provide, it was argued that the scientists should "*share a smaller number of computers if these computers were connected together by means of a data network*"<sup>38</sup>; and thus the first form of the Internet, known as ARPANet, came into being.<sup>39</sup>

The internet, simply put, is "*a worldwide system of computer networks – a network of networks in which users at any one computer can, if they have permission, get information from any other computer (and sometimes talk directly to users at other computers)*".<sup>40</sup> A side benefit of ARPANet's original design was that, "*because messages could be routed or rerouted in more than one direction, the network could continue to function even if parts of it were destroyed in the event of a military attack or other disaster*"<sup>41</sup>. This aspect of ARPANet's design may still be found in modern day Internet. And, while ARPANet was designed

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<sup>38</sup> Leonard Kleinrock's Personal History/Biography, The Birth of the Internet. Available at <http://www.lk.cs.ucla.edu/LK/Inet/birth.html> [Accessed 20/06/2008]

<sup>39</sup> *Internet History - - One Page Summary*. Available at [http://www.livinginternet.com/i/ii\\_summary.htm](http://www.livinginternet.com/i/ii_summary.htm) [Accessed 20/06/2008]

<sup>40</sup> TechTarget. Available at [http://searchwindevelopment.techtarget.com/sDefinition/0..sid8\\_gci212370.00.html](http://searchwindevelopment.techtarget.com/sDefinition/0..sid8_gci212370.00.html) [Accessed 17 June 2008]

<sup>41</sup> Whatis.com. *Internet Definition*. Available at [http://searchwindevelopment.techtarget.com/sDefinition/0..sid8\\_gci212370.00.html](http://searchwindevelopment.techtarget.com/sDefinition/0..sid8_gci212370.00.html) [Accessed 17/06/2008]

and implemented for governmental and military purposes, modern Internet has become a “*public, cooperative, and self-sustaining facility accessible to hundreds of millions of people worldwide*”<sup>42</sup>.

### Web Sites / Web sites

The term Web site may take several forms, including ‘Web presence’, ‘Web site’, ‘Internet presence’.<sup>43</sup> So what is a ‘Web site’? Simply put, a Web site is a collection of Web pages.<sup>44</sup> In other words, a Web site “*is a related collection of World Wide WEB [hereinafter referred to as WWW] files that includes a beginning file called a home page*”<sup>45</sup>. The ‘home page’ is used as the address by means of which an individual user can access a Web site. A user may obtain access to all the other Web pages on a Web site from the ‘home page’. Large Web sites, which would consist of several Web pages, can be spread over a number of ‘servers’ that are located in different geographical locations.<sup>46</sup>

It may be interesting to note that the term ‘site’ contained within a Web site is often confused with a ‘Web server’ due to the fact that ‘site’ implies a geographic location. However, “*a server is a computer that holds the files for one or more ‘sites’*”<sup>47</sup>. Furthermore, a Web site cannot be confined to one geographic location, as a Web site is “*somewhere in cyberspace*”<sup>48</sup>.

### Internet Service Providers

In short, an ISP provides access to the Internet. Furthermore, “*an ISP has the equipment and the telecommunication line access required to have a ‘point-of-presence’ on the Internet for the geographic area served*”<sup>49</sup>. In other words, an ISP is necessary in order to provide the user access from the physical world into

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<sup>42</sup> *ibid*, TechTarget

<sup>43</sup> Different terminologies found at [http://searchsoa.techtarget.com/sDefinition/0..sid26\\_gci213352.00.html](http://searchsoa.techtarget.com/sDefinition/0..sid26_gci213352.00.html) and <http://www.webopedia.com/TERM/P/presence.html> [Accessed both 20/06/2008]

<sup>44</sup> TechTerms.com. Available at <http://www.techterms.com/definition/website> [Accessed 20/06/2008]

<sup>45</sup> *ibid*, TechTarget

<sup>46</sup> *ibid*

<sup>47</sup> *ibid*

<sup>48</sup> *ibid*

<sup>49</sup> TechTarget. Available at

[http://searchwindevelopment.techtarget.com/sDefinition/0..sid8\\_gci214028.00.html](http://searchwindevelopment.techtarget.com/sDefinition/0..sid8_gci214028.00.html) [Accessed 20 June 2008]

the 'virtual world'. Furthermore, the geographic location of an ISP is determinable as the ISP uses physical tangible equipment.

### **"Load Balancing"**

The expansion of the Internet and E-commerce has resulted in an exponential increase in 'web traffic'. A 'White Paper' issued by the 3Com Corporation in 2002 sets out a simple explanation of what 'web traffic' is and how it is caused:

*"...the infrastructure of the Internet, and the World Wide Web built on top of it, is inherently inefficient. Underneath the breathtaking technology and capabilities of the Internet lies a distribution model that is still fairly unsophisticated. Typically, every time someone views online content it has been obtained directly from the server where the source information is stored.*

*To appreciate the problems inherent in this system, imagine if water was delivered to the public in the same way the Internet delivers information to users. Currently, water is stored in local reservoirs and piped directly into homes and businesses. Imagine instead if there were only a single distribution point – say a well in Ohio. Anytime someone needed water, anywhere in the country he or she would have to drive to Ohio, fill up some water tanks at the well, and drive home. Now if you imagine the traffic jams that would occur for miles around the well, you begin to understand why users can experience such slow and frustrating response times from the Internet."<sup>50</sup>*

In order to reduce this 'Web traffic' problem and increase the Internet performance, the 'Web traffic', especially in the last few years, is distributed over several servers in order to 'balance the usage load'. 'Load balancing', in turn, has been defined as "*the fine tuning of a computer system, network or disk subsystem in order to more evenly distribute the data and/or processing across available resources. For example, in clustering, load balancing might distribute the incoming transactions evenly to all servers, or it might redirect them to the next available server*"<sup>51</sup>. In other words, 'load balancing' is the use of several servers running a Web application simultaneously. Furthermore, 'load balancing' operates

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<sup>50</sup> 3Com Corporation. *White Paper, Web Caching: Optimizing for Internet and Web Traffic*. (2002) p2. Available at [http://www.3com.com/other/pdfs/infra/corpinfo/en\\_US/503093.pdf](http://www.3com.com/other/pdfs/infra/corpinfo/en_US/503093.pdf) [Accessed 13/06/2008]

<sup>51</sup> Answers.com. Available at <http://www.answers.com/topic/load-balancing-computing?cat=technology> [Accessed 13/06/2008]

in such a way that it appears to the world as if there is only a single server running the Web application.<sup>52</sup>

Another important aspect of ‘load balancing’ is that it adds more connection efficiency – should one ISP fail to connect to the Internet, the connection is routed to another ISP reducing the possibility of total connection failure.<sup>53</sup>

### E-Commerce

Electronic Commerce (also referred to as eCommerce and E-commerce) may be defined as:

*“a way of doing real-time business transactions via telecommunications networks, when the customer and the merchant are in different geographical places... Electronic commerce operates on a bona fide basis, without prior arrangements between customers and merchants. E-commerce operates via the Internet using all or any combination of technologies designed to exchange data, to access data, and to capture data...”<sup>54</sup>*

A more simplified definition of Electronic Commerce is the *“buying and selling of goods and services on the Internet, especially the World Wide Web”<sup>55</sup>*. E-commerce activities may be broken down into two different categories, namely “business-to-business” and “business-to-consumer”. “Business-to-business” E-commerce makes use of the Internet *“to integrate the value-added chain that can extend from the supplier of raw materials to the final consumer”<sup>56</sup>*. The “business-to-consumer” E-commerce activities receive the most amount of attention, despite the fact that the “business-to-business” E-commerce activities actually represent

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<sup>52</sup> Viswanathan, Vivek. *Load Balancing Web Applications* (2001). Available at <http://www.onjava.com/pub.a/onjava/2001/09/26/load.htm> [Accessed 13/06/2008]

<sup>53</sup> Tyson, Jeff. *How Network Address Translation Works, Multi-Homing*. Available at <http://computer.howstuffworks.com/nat6.htm> [Accessed 23/06/2008]

<sup>54</sup> Telecom Glossary 2K. *e-commerce* (2002). Available at [http://www.its.bldroc.gov/projects/devglossary/\\_e-commerce.html](http://www.its.bldroc.gov/projects/devglossary/_e-commerce.html) [Accessed 26/06/2008]

<sup>55</sup> SearchCIO.com Definitions, TechTarget. *E-commerce*. Available at [http://searchcio.target.com/sDefinition/0,,sid182\\_gci212029,00.html](http://searchcio.target.com/sDefinition/0,,sid182_gci212029,00.html) [Accessed 26/06/2008]

<sup>56</sup> Pinto, Dale. Doctor of Philosophy Thesis: *E-Commerce and Source-based Income Taxation* (March 2002). Available at [http://ibfd.org/mkt/vol6\\_introduction.pdf](http://ibfd.org/mkt/vol6_introduction.pdf) [Accessed 26/06/2008]. Also, available at [http://books.google.co.uk/books?id=7ZTacY4W0SwC&pg=PR9&lpg=PR9&dq=Chapter+1:+INTRODUCTI+ON,+1.1.+Definition+of+electronic+commerce+and+overview+of+how+it+operates&source=web&ots=18lWY3L-84&sig=mhgF8xfWNb-SJI\\_1AoMhWZ\\_ypjU&hl=en&sa=X&oi=book\\_result&resnum=2&ct=result](http://books.google.co.uk/books?id=7ZTacY4W0SwC&pg=PR9&lpg=PR9&dq=Chapter+1:+INTRODUCTI+ON,+1.1.+Definition+of+electronic+commerce+and+overview+of+how+it+operates&source=web&ots=18lWY3L-84&sig=mhgF8xfWNb-SJI_1AoMhWZ_ypjU&hl=en&sa=X&oi=book_result&resnum=2&ct=result) [Accessed 19 May 2008]

the bulk of all E-commerce. “Business-to-consumer” E-commerce is the retailing (otherwise referred to as the “e-tailing”) segment of E-commerce.<sup>57</sup>

It should be noted that E-commerce is generally “conducted through the Internet [by means] of three parties, namely the ISP, the trader and the customer”<sup>58</sup>.

### Illustrative Example

For purposes of this illustrative example, a commonly known Web site name has been used, that is, Amazon.com<sup>59</sup>. The use and application of such a Web site, within the context of this example, does not imply nor mean that this is necessarily how Amazon operates. All countries, locations of ISPs and quantity of ISPs used within the context of this example are hypothetical. It may be argued that the quantity of ISPs utilized within this example is excessive, however this ‘excessive’ quantity has been used to illustrate the fact that such a network connection and structure can exist.

At one point, when the address www.amazon.com was entered, the user was taken to the Amazon Web site hosted on an ISP in California, USA. The entire Web site, inclusive of all the Web pages, was hosted on this one ISP in California.

However, over the years the Internet usage has grown to such an extent that one ISP was unable to handle the increased ‘Web traffic’. Too many users attempting to access one Web site, all Web pages inclusive, hosted on one ISP

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<sup>57</sup> ibid

<sup>58</sup> ibid

<sup>59</sup> “Amazon.com, the world’s largest online retailer with nearly \$15 billion in annual sales in 2007, is one of the iconic companies of the Internet era.

*It was founded in 1994 by Jeffrey P. Bezos, a former financial analyst for the New York hedge fund D.E. Shaw & Company who, legend has it, set out on a drive from Texas to Seattle with his wife, writing an ambitious business plan for an online bookstore along the way.*

*But books were just the beginning. Amazon soon began methodically expanding from one product category to another: CDs, movies, toys, furniture, groceries. Today the company and its partners sell everything from jewellery to golf gear on Amazon.com. The company went public on May 15, 1997, but did not make a profit until 2002. Its stock was hammered during the dot-com bust but, by 2007, was on the upswing, aided by the migration of consumers to the Web, growing trust in e-commerce and Amazon’s overall reputation for good prices, broad selection and convenience.” Available at [http://topics.nytimes.com/top/news/business/companies/amazon\\_inc/index.html?inline=nyt-org](http://topics.nytimes.com/top/news/business/companies/amazon_inc/index.html?inline=nyt-org) [Accessed 23/06/2008]*

caused a bottleneck resulting in the access to Amazon becoming 'jammed' and inaccessible. To resolve the problems caused by congested 'Web traffic', Amazon started utilizing multiple ISPs in a 'load balancing' scheme. Thus, a typical 'movie' purchase over Amazon now results in the use of several ISPs hosted in several countries. For example:

1. A user in Cape Town, South Africa enters the Web site address [www.amazon.com](http://www.amazon.com) in search of movies. The user is taken to the 'Amazon Home Page' which may be hosted on an ISP in California, USA.
2. The user selects 'movies' and is taken to a new Web page that lists all the available 'movies'. This 'new Web page' may be hosted on an ISP in Berlin, Germany.
3. Next, the user selects the 'movie' he wishes to purchase, and is taken to a new Web page that contains all the details for the chosen 'movie'. This Web page may be hosted on an ISP in New York, USA.
4. Next, the user will select "PAY NOW", and this takes the user to yet another Web page for the user to enter his credit card details. This Web page may be hosted on an ISP in London, United Kingdom.
5. After the user's credit card details have been entered, the user selects "PROCEED" for the payment to be authorised and finalised. This payment confirmation occurs as follows:
  - i. Amazon connects to its bank in Switzerland, where the Swiss bank proceeds with the payment confirmation and finalisation. The Swiss bank uses an ISP hosted in Switzerland.
  - ii. In order to authorise payment, the Swiss bank connects to the Amazon customer's local bank, i.e. Investec. Investec in turn will confirm that the customer has sufficient funds and, in doing so,

Investec's ISP will be used which is hosted in Johannesburg, South Africa.

- iii. Once authorisation has been granted, Investec will connect back to the Swiss bank relaying the relevant information, and the Swiss bank will in turn relay back to the Amazon Web page, hosted in New York, USA, which will then allow Amazon to proceed to the final Web page of the transaction – the 'movie' downloading Web page.
6. The 'movie' downloading Web page may be hosted on an ISP located in Hong Kong. Once the customer selects "DOWNLOAD", the "DOWNLOADING" application is then shifted over to the customer's ISP, located in Cape Town, South Africa, and, as such, utilizes the customer's ISP in order to complete the transaction.

Furthermore, the route used in the example above will not necessarily be the route used each time a user wishes to purchase a 'movie' from Amazon. For example, should the Web traffic to the Web page that lists all the available 'movies' (hosted on an ISP in Berlin, Germany) be too great, the user will automatically be re-routed to another Web page listing all the available 'movies' which may be hosted on an ISP in Dublin, Ireland.

Throughout this entire transaction, the customer has been under the impression that as he accessed 'Amazon America' he has been connected to one ISP located in the USA. Whereas, in actual fact, this one transaction has resulted in the use of eight (8) different ISPs in six (6) different countries.

## **CHAPTER THREE**

### **INTERNATIONAL TAX AND DOMESTIC TAX**

'Jurisdiction to tax' is comprised of two basic methods of imposing taxation, namely, 'residence basis taxation' or 'source basis taxation', and in some States, a combination of these two taxing methods is utilized. 'Source' and 'residence' are both domestic tax and international tax concepts and are the main basis of international taxation. Different States might follow and practice different taxation systems, such as 'residence basis tax' or 'source basis tax' or maybe even a combination of both. But even States that follow the same taxing system, say 'source basis taxation', might have different definitions of 'source based' income. These tax systems are implemented in Domestic Tax Laws and, therefore, an understanding of these different taxing systems is necessary for purposes of International Tax. As previously stated, no international tax laws, per se, actually exist. International Taxation is rather '*a subject of study that deals with international tax treaties and international aspects of domestic income tax laws*'<sup>60</sup>. Thus, examining the definition of 'source' and 'residence' is required. Furthermore, an understanding of the OECD, Double Tax Agreements (hereinafter referred to as DTAs) and application thereof shall be explored and detailed.

#### **OECD and Double Tax Agreements**

Taxpayers may utilize a DTA, in obtaining double tax relief, only if the taxpayer is a resident (as shall be defined later) in at least one of the two States where tax is being imposed on the taxpayer's income. There are two different types of double taxation that may occur, Juridical Double Taxation and Economic Double Taxation. DTAs are applied in obtaining relief from such Double Taxation. Juridical Double Taxation is where the same taxpayer is taxed in two or more States on the same income. For example, Mr X earns royalties in State A and is a resident in State B. As such, both States impose tax on the royalties earned by Mr X. In such an instance, Mr X may apply the DTA to obtain double tax relief, provided a DTA exists between State A and State B.

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<sup>60</sup> Refer to Chapter One under 'The Development of International Tax'  
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However, where Economic Double Taxation arises, the taxpayer/s involved will not be entitled to utilize a DTA to obtain double tax relief. Economic Double Taxation is where different taxpayers are taxed on the same income. For example, some countries treat Partnerships as a company and some countries tax the individuals within the Partnership. For example, Partnership ABC earns royalties in State A where Partnerships are taxed as a company, or the Partnership is resident in State B where the individuals of the Partnership are taxed. If the Partnership is taxed in both State A and B, such double taxation is Economic Double Taxation and the taxpayer will not be able to apply the DTA to obtain double tax relief.<sup>61</sup>

The OECD, as previously stated, promotes international co-operation in taxation between member States. Member States, and even some non-member States, upon concluding or revising bilateral agreements, have largely conformed to the OECD Model Convention. Thus, the existence of the OECD Model Convention has “*made possible a desirable harmonization between their bilateral conventions for the benefit of both taxpayers and national administrations*”<sup>62</sup>

The OECD Model Convention specifies a single rule, where possible, for each situation that may arise. However, there are certain points that require a degree of flexibility to allow member States some latitude. And in some cases, the OECD provides alternative or additional provisions in the Commentaries to the OECD Model Convention. The Commentaries to the OECD Model Convention are not legally binding but are of assistance in the application and interpretation of the Model Convention. Furthermore, “*as the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of Member countries, they are of special importance in the development of international fiscal law*”.<sup>63</sup>

### ‘Residence’

In order to determine ‘residence’ for purposes of taxation, different definitions have been examined and explored by tax authorities around the world. One such definition, as defined by South African courts, is a taxpayer’s ‘ordinary residence’.

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<sup>61</sup> *ibid*, *International Tax A South African Perspective 2008*, 13

<sup>62</sup> *OECD Model Tax Convention on Income and on Capital, Condensed Version, July 2005* (2005), 10

<sup>63</sup> *ibid*, *Model Tax Convention on Income and Capital 14*

'Ordinary residence' has been defined as the "country to which [the taxpayer] would naturally and as a matter of course return from his wanderings"<sup>64</sup>. Thus, in terms of such a definition, a taxpayer who meets the definition of 'residence' is taxed on his worldwide income regardless of the 'source' of the income. There have been arguments that the definition of 'residence' differs from the definition of 'ordinarily resident'.<sup>65</sup> There is also tax court case authority arguing that 'ordinarily resident' and 'resident' differ little in meaning:

*"the expression 'ordinary residence'... connotes residence in a place with some degree of continuity and apart from temporary absences. So understood, the expression differs little in meaning from the word 'residence' as used in the Acts; and I find it difficult to imagine a case in which a man while not resident here is not ordinarily resident here."*<sup>66</sup>

However, some countries' legislation and court cases (e.g. South Africa) have made a distinction between the two definitions. It is important to note that in terms of the South African legislation, section 1 of the Income Tax Act, No.58 of 1962 (hereinafter referred to as the SA Income Tax Act), specifically defines 'resident', with respect of natural persons, as "any natural person who is ordinarily resident in [South Africa]"<sup>67</sup>. Within in the Commissioner for Inland Revenue (hereinafter referred to as CIR) v Kuttel 54 SATC 298<sup>68</sup> case (hereinafter referred to as the Kuttel case), a South African resident applied for and received a USA Permanent Resident permit. After receiving the USA residence permit, Kuttel, along with his wife and kids, emigrated to the USA where he rented a house, established Church membership, opened a bank account, acquired an office, bought a car and registered with Social Security. During a 31-month period, that was under review by the South African Revenue Services (hereinafter referred to as SARS), Kuttel visited South Africa up to a third of the 31 months. Kuttel retained a house in South Africa, and even effected some improvements to the house during this period. Judge Corbett, within the Kuttel case, held that "the words 'ordinarily resident' were something different and were narrower than just 'resident'"<sup>69</sup>. Judge Corbett, furthermore, held that "the formulation of Schreiner JA in the *Cohen v Commissioner for Inland Revenue* 13 SATC 362 should be

<sup>64</sup> CIR v Lever Brothers and Unilever Ltd 1946 AD 441, 14 SATC 441 at 449. Also, T S Emslie SC, et al *Income Tax Cases & Materials* 3ed (2001) 104

<sup>65</sup> De Koker et al *Silke on South African Tax Memorial Edition* (2006) 5-4

<sup>66</sup> *Levene v IRC* (1928) AC 217

<sup>67</sup> "Resident" (a) (i) of Section 1 of the South African Income Tax Act, No. 58 of 1962

<sup>68</sup> 1992 (3) SA 242 (A)

<sup>69</sup> *ibid*, 300

*adopted – that a person is ‘ordinary resident’ where he has his usual or principal residence, i.e. what may be prescribed as his real home.*”<sup>70</sup> Thus, in terms of the Kuttel case, Kuttel was deemed to be ordinarily resident in the USA.

It has been argued that ‘residence basis taxation’ system ensures ‘capital export neutrality’.<sup>71</sup> In other words, *“the best possible efficiency in allocation is obtainable by worldwide taxation in the State of residence and credit being allowed there for tax imposed by the State of source”*<sup>72</sup>.

The principle of taxing ‘residents’ of a State is often followed with the justification that *“residents enjoy the protection of the State [in which they reside], and should therefore contribute to the cost of the government of the country in which they reside, even with tax on income earned [i.e. sourced] outside that State”*<sup>73</sup>.

While ‘residence’ basis tax operates on the concept of taxing a ‘resident’ of that State on their worldwide income, it should be noted that an element of ‘source’ basis taxation exists. That is, States operating on ‘residence basis’ will also tax non-residents on their income generated within the domestic economy.

Furthermore, the administrative capacity required for taxing ‘residents’ on their worldwide income may be too costly or unachievable, and thus the ‘residence minus’ approach is often adopted. The ‘residence minus’ approach exempts certain categories of income from tax.<sup>74</sup> Residence base taxation is a preferred revenue collection method due to the fact that taxpayers often channel their income to countries with usually lower tax rates than that of the taxpayer’s resident country. However, it should be noted that in order to implement a residence basis of taxation, the State requires an administrative capacity, and as such, developing and emerging countries often do not implement or follow the residence basis of taxation.<sup>75</sup>

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<sup>70</sup> *ibid*, 301

<sup>71</sup> *ibid*, Klaus Vogel on Double Tax Conventions, 6

<sup>72</sup> *ibid*

<sup>73</sup> Republic of South Africa, Fifth Interim Report of the Commission of Inquiry into certain Aspects of the Tax Structure of South Africa *Basing the South African Income Tax System on the Source or Residence Principle – Options and Recommendations* (1997) 4. Also referred to as the KATZ Commission. Available at <http://www.polity.org.za/polity/govdocs/commissions/katz-5.htm> [Accessed 13 May 2008].

<sup>74</sup> *ibid*, *International Tax A South African Perspective 2005*, 43 & 51

<sup>75</sup> *ibid*

Klaus Vogel (hereinafter referred to as Vogel) referred to residence base taxation as the 'sacrifice theory'. Taxes imposed under the residence basis of taxation "are viewed as a sacrifice owed to a country due to the higher moral value of community purposes over individual aim".<sup>76</sup>

The OECD Double Tax Convention defines 'resident' in Article 4 as follows:

*"1. For the purposes of this Convention, the term 'resident of a Contracting State' means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. But this term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein"*<sup>77</sup>

The OECD Model Convention, as well as the UN Model Convention, views the criteria of 'residence' as being "exclusively locality related".<sup>78</sup>

The above defines 'residence' in terms of individuals. The definition of 'residence' for an individual differs from that of a company. In terms of South Africa, a company is classified and defined as resident in South Africa if incorporated, established, formed or has its 'place of effective management' in South Africa.<sup>79</sup> However, it has been argued that the place where a company is registered, i.e. incorporated, has become increasingly irrelevant in determining 'residence' due to the growth of E-commerce.<sup>80</sup>

In terms of the Article 4 of the OECD Model Convention "a person other than an individual is a resident of both Contracting States, then [the company liable to taxation] shall be deemed to be a resident of the State in which its **place of effective management is situated**".<sup>81</sup>

The OECD Model Convention Commentary has defined 'Place of effective management' as follows:

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<sup>76</sup> Dale Pinto, *E-Commerce and Source-Based Income Taxation*. Available at [http://books.google.co.uk/books?id=7ZtacY4WOSwC&pg=PA48&dg=Definition+of+Source+for+Tax&source=web&ots=18ITVZGSb\\_&sig=xTwqEyiBdDKJmohmkQzP-OHRz1c&hl=en#PPT1.M1](http://books.google.co.uk/books?id=7ZtacY4WOSwC&pg=PA48&dg=Definition+of+Source+for+Tax&source=web&ots=18ITVZGSb_&sig=xTwqEyiBdDKJmohmkQzP-OHRz1c&hl=en#PPT1.M1) [Accessed 19 May 2008]. Also, Klaus Vogel, *Worldwide vs Source Taxation of Income – A Review and Re-evaluation of Arguments (Part III)* (1998) 11 *Intertax* 393,394

<sup>77</sup> OECD, *Article 4 (1) Model Tax Convention on Income and on Capital, Condensed Version – July 2005* (2005) 26

<sup>78</sup> *ibid*, Klaus Vogel on *Double Tax Conventions*, 149

<sup>79</sup> *ibid*, *International Tax A South African Perspective 2005*, 54

<sup>80</sup> *Taxation of Electronic Commerce* 62. Available at

<http://www.laws4india.com/indiantaxlaws/notification/ecomchapter2.pdf> [-Accessed 14 May 2008]

<sup>81</sup> *ibid*, Klaus Vogel on *Double Taxation Convention* 144

*“the place where the key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.”*<sup>82</sup>

SARS has provided an Interpretation Note in an attempt to provide clarity to the meaning of the term ‘place of effective management’. This ‘Interpretation Note’ distinguishes between the place where:

- i. *“Central management and control are carried out by a board of directors;*
- ii. *Executive directors or senior management execute and implement policy and strategic decisions made by the board of directors and make and implement day-to-day / regular /operational management and business activities; or*
- iii. *The place where the day-to-day business activities are carried out / conducted”*.<sup>83</sup>

Furthermore, the place where the directors or senior managers of the business manage the company on a day-to-day basis is where the decisive ‘place of effective management’ is determined.<sup>84</sup>

However, like ‘residence’, there is no one definition for ‘*place of effective management*’. While the term ‘*place of effective management*’ is utilised in several States as well as Model Tax Conventions, including the OECD, UN and USA, and thus the definition varies and is not precise.

It has been suggested that the definition of ‘residence’, for both natural persons and others, should be aligned, in several respects, with international norms.<sup>85</sup> The importance of this ‘alignment’ is that ‘residence’ plays a vital role in International Taxation and the application of DTAs, in order to determine whether a DTA is applicable. In other words, for a DTA to apply, the party involved must be a ‘resident’ in at least one of the two States where the tax dispute has arisen.

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<sup>82</sup> *ibid*, OECD Model Tax Convention on Income and on Capital 82

<sup>83</sup> *ibid*, International Tax A South African Perspective 2005, 55

<sup>84</sup> *ibid*

<sup>85</sup> *ibid*, KATZ Commission, 39

Furthermore, 'residence' lies at the heart of 'jurisdictional right to tax'<sup>86</sup>. "*This 'jurisdictional right to tax' is a central principle of international taxation.*"<sup>87</sup>

While the term and definition of 'residence' may appear to be straightforward, different definitions do exist for different countries. There is a possibility of contradicting definitions between two countries, resulting in a taxpayer being classified as a resident in more than one country during a given tax period.<sup>88</sup> In such circumstances these two countries should look to the definition of 'residence' as defined within the DTA between the two 'Contracting States', should a DTA exist between the two 'Contracting States'.

### **Permanent Establishment**

'Permanent establishment' is defined under Article 5 of the OECD Model Convention. Here 'permanent establishment' is defined as a "*fixed place of business through which the business of an enterprise is wholly or partly carried on*"<sup>89</sup>. The purpose for examining the definition and application of 'permanent establishment' is that, in terms of the OECD Commentary, "*the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State*"<sup>90</sup>. In other words, a Contracting State (i.e. State A) may not tax the business profits of an enterprise deemed to be a resident of another Contracting State (i.e. State B) unless the enterprise is conducting business through a 'permanent establishment' within State A. Thus, the definition and understanding of 'permanent establishment' may be viewed as a preamble to understanding the definition of 'source', for purposes of this paper, and as stated by the OECD:

*"The permanent establishment concept also acts as a source rule to the extent that, as a general rule, the only business profits of a non-resident that may be taxed by a country are those that are attributable to a permanent establishment"*<sup>91</sup>.

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<sup>86</sup> *ibid*, *The International Taxation System*, 6

<sup>87</sup> *ibid*, 5

<sup>88</sup> *ibid*, *The International Taxation System*, 7

<sup>89</sup> *ibid*, *The International Taxation System*, 9. Also, *ibid*, *Klaus Vogel on Double Tax Conventions*, 191

<sup>90</sup> *ibid*, *OECD Model Tax Convention on Income and on Capital* 85

<sup>91</sup> OECD Tax Policy Studies *E-commerce: Transfer Pricing and Business Profits Taxation (2005)* 77

Three elements may be clearly identified within the definition of ‘permanent establishment’, as defined under Article 5 of the OECD Model Convention above:

- i. Does the enterprise have a ‘place of business’,
- ii. Which is fixed, and
- iii. Is the business of the enterprise carried on through this ‘fixed place of business’?<sup>92</sup>

It is important to establish whether the enterprise has a ‘place of business’, as a ‘permanent establishment, in terms of the OECD Model Convention and will only exist where an enterprise has a physical presence within the Source State. Furthermore, it is required that the enterprise be conducted through a fixed ‘place of business’ in order to qualify as a permanent establishment and not through, for example, another place of business within the Source State that does not qualify for permanent establishment. We then arrive at the crucial point, for purposes of this paper, which requires careful examination in determining permanent establishment – when has the enterprise met the definition of ‘fixed’? In order to meet the definition of ‘fixed’ two components must exist in relation to the enterprise:

- i. “Location Test” – is there a specific geographical spot that exists?
- ii. “Duration Test” – is there a certain degree of permanence at the ‘location’ of the enterprise?

With regards to applying the “**Location Test**” “*the key requirement is that the business should commercially and geographically consist of a coherent whole. An important factor in this regard is whether the enterprise regularly returns to a specific location*”<sup>93</sup>. The relevance of examining the “fixed” location criteria pertains to the appropriateness of such practice with modern day trading, i.e. E-commerce. In other words, due to the creation and use of E-commerce, it is possible for enterprises to conduct business operations within a country without having to have a ‘fixed place of business’ within that country.<sup>94</sup> It is within this

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<sup>92</sup> *ibid*, *International Tax, A South African Perspective 2008, Fourth Edition* (2008) 95

<sup>93</sup> *ibid*, *International Tax, A South African Perspective 2008, Fourth Edition* (2008) 97

<sup>94</sup> *ibid* 98

context that the OECD discussion document pertaining to the clarification on the application of the permanent establishment definition in E-commerce examines “*how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules*”<sup>95</sup>.

The following views have also been established in the context of this discussion paper:

- i. “*A web site cannot, in itself, constitute a permanent establishment;*
- ii. *A web site hosting arrangement typically does not result in a permanent establishment for the enterprise that carries on business through that web site; and*
- iii. *An ISP will not, except in very unusual circumstances, constitute a dependent agent of another enterprise so as to constitute a permanent establishment of that enterprise...;*
- iv. *[Furthermore, having examined] ...the issue, the conclusion has been reached that human intervention is not a requirement for the existence of a permanent establishment...”*<sup>96</sup>

In terms of the OECD Model Tax Convention Commentary the issue as to whether an ISP constitutes an ‘agent’ and, therefore, a permanent establishment has been addressed (as stated above). The OECD Model Tax Convention Commentary notes the commonality of ISP’s providing web site hosting services for other enterprises on their own servers. However, the OECD Commentary continues to state that “*the ISPs will not constitute an agent of the enterprise to which the web sites belong, because they will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business... [and, therefore,] cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise... ”*<sup>97</sup>.

The analysing of ‘agents’, for purposes of exploring the definition of “Permanent Establishment”, is a topic on its own and falls primarily outside of the ambit of this paper’s topic and, as such, will not be explored or discussed in depth. However, in light of the above, and for the examination of the definition of ‘permanent establishment’ within the context of E-commerce, a brief

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<sup>95</sup> OECD Committee on Fiscal Affairs *Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5 (2000)* 2

<sup>96</sup> *ibid* 3

<sup>97</sup> *ibid*, *OECD Model Tax Convention on Income and on Capital* 106

understanding of 'agent' is, nevertheless, required with regards to ISPs, web sites and agency discussion, hence the brief overview provided below.

A common trait of the Model Conventions is that a 'dependent agent' may result in a permanent establishment being formed. The term 'agent' is defined in the Oxford Dictionary as "*a person whose job is to act for, or manage the affairs of, other people in business...*"<sup>98</sup>. Otherwise defined as "*one authorised to carry on business or affairs for another*"<sup>99</sup>.

The OECD Model Convention goes on to distinguish between an "independent agent" and a "dependent agent", whereby the latter generally falls within the ambit of the Permanent Establishment definition. Vogel lays out the provision whereby an "independent agent" generally does not constitute a Permanent Establishment of the enterprise. This provision being that the "independent agent" "*continues to be independent of the enterprise both legally and economically and, when exercising activities on behalf of the enterprise, acts in the ordinary course of his business*"<sup>100</sup>. Other guidelines in determining whether an individual or juristic person is a dependent or independent agent require determining the following factors:

- "*the amount of freedom he or she has to enter into contracts on behalf of the enterprise, for example, operating under detailed instructions and control indicate a dependent status; and*
- *entrepreneurial risk: if the risk is borne by the agent, he or she acts independently*"<sup>101</sup>

A crucial criterion for an agent to meet the definition of "dependent" is that the agent must have the ability to negotiate and conclude contracts on behalf of the enterprise. This being stated, the agent must, nevertheless, habitually exercise such authority. In other words, "*the person making use of the authority must do so repeatedly and not merely in isolated cases*"<sup>102</sup>. It is, furthermore, interesting to note that the UN Model Convention proceeds one step further than the OECD Model Convention by providing that where an agent is without authority to conclude contracts on behalf of the enterprise, the agent may still meet the

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<sup>98</sup> Oxford University Press, 2005. Available at [http://www.oup.com/oald-bin/web\\_getald7/index1a.pl](http://www.oup.com/oald-bin/web_getald7/index1a.pl) [Accessed 24/07/2008]

<sup>99</sup> Franklin Electronic Publishers, 1995. *Dictionary & Thesaurus*.

<sup>100</sup> *ibid*, Klaus Vogel on Double Taxation Convention 257

<sup>101</sup> *ibid*, International Tax A South African Perspective 2008, 105

<sup>102</sup> *ibid*

definition of “dependent agent” where the agent “*habitually maintains [in the host State] a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise*”<sup>103</sup>.

In terms of satisfying the “**duration test**” there must be a certain degree of permanence. Lynette Olivier and Michael Honiball have submitted this to mean “*that is not so much the activities that need to be exercised with the necessary degree of permanence but rather that the place of business needs to be set up with a certain degree of permanence*”<sup>104</sup>. It is further submitted that “fixed” should not be interpreted to mean that there may be no interruption in business operations, but rather that business operations should be conducted on a regular basis in order to satisfy the “duration test”.<sup>105</sup> In terms of International tax case law, the Transvaal Associated Hide and Skin Merchants case<sup>106</sup> may be relied upon for precedence on business operations being conducted at a ‘fixed’ location, thereby giving rise to tax liability at such location of permanence. In other words, as the business operations of a South African company were conducted at a location, situated in Botswana, operating on a regular basis, such location was deemed to result in the Transvaal Associated Hide and Skin Merchants having a ‘permanent establishment’ in Botswana as the activities in Botswana constituted the “*dominant, main, substantial or real and basic cause of the accrual of the income*”<sup>107</sup>; i.e. the ‘source’ was located in Botswana. The concept of ‘source’ will be examined further on.

The final element of the definition of ‘permanent establishment’ requires the examination of whether business has been carried on through a fixed place of business. The OECD Commentary has defined this to mean “*that [the] persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated*”<sup>108</sup>. In other words, the business of an enterprise, whether wholly or partly, may not be

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<sup>103</sup> Article 5(b), *Permanent Establishment, of the UN Model Tax found in Klaus Vogel on Double Taxation Convention* 194

<sup>104</sup> *ibid*, *International Tax a South Africa Perspective 2008*, 99

<sup>105</sup> *ibid*

<sup>106</sup> *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax, Botswana 29 SATC 97 1967*. (BC)

<sup>107</sup> T S Emslie SC, et al *Income Tax Cases & Materials* 3ed (2001) 124

<sup>108</sup> *ibid*, *OECD Model Tax Convention on Income and on Capital*, 85

conducted through another enterprise that does not qualify as a permanent establishment in the foreign State.<sup>109</sup>

### 'Source'

'Source basis' taxation, briefly defined, is the 'originating cause of its receipt' and 'not the quarter from which it comes'.<sup>110</sup> Thus, one must examine "what [gave] rise to the income?"<sup>111</sup>. In order to answer this question, the originating cause the taxpayer performed in order to generate the income must be determined.<sup>112</sup> In short, and as stated in a Rhodesian<sup>113</sup> tax case<sup>114</sup>, "*source means not a legal concept but rather something which a practical man would regard as the real source of income*"<sup>115</sup>. The income is taxable in the State where the source of income is determined. However, it is possible, as has been ruled in tax court cases, for there to be more than one originating cause. One such tax case was the South African tax case, *CIR v Black*<sup>116</sup>, where the court concluded that the "*main, the real, the dominant, the substantial source of the amounts accrued was the use of the taxpayer's capital in London, and the entering into and carrying out of the share dealing transactions in London*"<sup>117</sup>.

In the *Black* case the taxpayer was a stockbroker on the Johannesburg Stock Exchange. The taxpayer opened what is referred to as a "Speculation Account" in London, England, where "speculative dealings in shares" were carried out. These "speculative dealings in shares" gave rise to debit and credits occurring on the taxpayer's "Speculation Account". Furthermore, the taxpayer authorised the London brokers to deal on his behalf without reference to him. While such authorisation had been granted it should be noted that in practice reference was in fact made to the taxpayer in almost all cases. The taxpayer made a profit from

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<sup>109</sup> *ibid*, *International Tax A South African Perspective* 2008, 99

<sup>110</sup> *ibid* 104

<sup>111</sup> *ibid*

<sup>112</sup> *ibid*

<sup>113</sup> **Rhodesia** is the "former name of a large territory in central-southern Africa, divided into Northern Rhodesia (now Zambia) and Southern Rhodesia (now Zimbabwe). The region was developed by and named after Cecil Rhodes, through the British South Africa Company, which administered it until Southern Rhodesia became a self-governing British colony in 1923 and Northern Rhodesia a British protectorate in 1924. From 1953 to 1963 Northern and Southern Rhodesia were united with Nyasaland (now Malawi) to form the federation of Rhodesia and Nyasaland". As per Encyclopedia.com et al A Dictionary of World History (2000). Available at <http://www.encyclopedia.com/doc/1O48-Rhodesia.html> [Accessed 5 January 2009]

<sup>114</sup> *Rhodesia Metals Ltd (In Liquidation) v COT* 11 SATC 244

<sup>115</sup> *ibid*. Also, *ibid*, *International Tax A South African Perspective* 44

<sup>116</sup> 957 (3) SA 536 (A), 21 SATC 226, 1957 Taxpayer 172 at 542. Also, *ibid*, *Income Tax Cases & Materials*

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<sup>117</sup> *ibid*

these London share dealings and SARS sought to include this profit in the taxpayer's taxable income in South Africa. It was determined, upon this matter proceeding to court, that a "*reasonable conclusion was that the main, the real, the dominant, the substantial source of the amount accrued was the use of the taxpayer's capital in London*"<sup>118</sup>. Thus, the profit could be said to have a dominant source in London and, therefore, not taxable in South Africa.<sup>119</sup>

In terms of Vogel's two competing theories regarding a State's right to tax income, 'source basis taxation' is the 'benefit theory'. In terms of the 'benefit theory' "*a jurisdiction's right to tax rests on the totality of benefits and state services provided to taxpayers that interact with a country*"<sup>120</sup>. Vogel's supporting argument to the benefit theory is that the "*country of source that...provided most or all of the benefits relevant for the production of income and therefore incurred costs in providing...[such] benefits*" should be entitled to exclusive taxation rights with regards to such income as 'compensation to the government' for bearing the costs incurred.<sup>121</sup>

Vogel's argument for a State's right to tax on 'source' income is not the only reasoning offered with regards to 'source basis taxation'. Another argument for 'source basis taxation' is based on the concept of "entitlement". The concept of "entitlement" is based on the source State being entitled to tax income generated within its geographic borders.<sup>122</sup> Furthermore, the fact that the income is generated within a State's geographical borders allows for that State to have the first opportunity to tax such income. Thus it may be difficult, from a practical point of view, to prevent States from taxing income generated within their borders.<sup>123</sup>

The South African tax case, *Lever Bros and Unilever Ltd*<sup>124</sup>, sets out a test in order to determine the 'source of income':

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<sup>118</sup> *ibid*, Black case. *Ibid*, *Income Tax Cases & Materials* 130

<sup>119</sup> *ibid*

<sup>120</sup> *ibid*, *E-commerce & Source-Based Income Taxation* 17

<sup>121</sup> *ibid* 19

<sup>122</sup> *ibid* 56

<sup>123</sup> *ibid* 41

<sup>124</sup> *Lever Brothers & Unilever, CIR v 1946 AD 441, 14 SATC 441* (hereinafter the "Lever Brothers case"). The Lever Brothers case laid down authority in South African tax case law that "source" means the "originating cause". Briefly, the facts and judgement of the Lever Brothers Case was as follows: A Dutch company held share in companies carrying on business in different parts of the world along with debts owed by certain Dutch companies. A South African company acquired the Dutch company, and as such took over the debt liability. The South African Commissioner sought to tax the interest paid by the South African

- i. The determination of the originating cause
- ii. The location of the cause once determined

In applying the above test, first the ‘originating cause’ of the generated income must be determined. Only after this has been established is the second part of the test examined; i.e. the State in which the activities are performed is determined.

Where it is found that there are more than two ‘originating causes’ relating to the generation of income, a distinction is made between the ‘dominant’ cause and the ‘incidental’ cause.<sup>125</sup> Furthermore, as it was held, “*in determining the source of income it must first be determined what the source is from which the income is derived and when this has been determined, the place where that source is located must be ascertained. The source of income is not the quarter from which it comes but rather the originating cause of its receipt*”<sup>126</sup>.

The South African tax case, *Millin v CIR*<sup>127</sup>, is an example of multiple source income. Millin was a novelist who wrote books in South Africa but published her works in the United Kingdom (hereinafter referred to as UK). Millin sought to have the Royalties, received as a result of these books, taxable in the UK only, or alternatively, to be apportioned between the UK and SA. However, the judge did not share the same view regarding the source of the income, nor that the income should be apportioned when a ‘dominant cause’ can be established. As per the judgment in the Rhodesian tax case, *W. Dunn & Co.*<sup>128</sup>, “*in the case of an ordinary business based upon capital it has been held that in determining the source of the income, regard must be had to the place where the capital was employed which produced the profits*”.<sup>129</sup> In Millin’s case, the capital was employed in the State where the books were written. When the ‘dominant’ cause

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company to its creditors based on the contention that the source of the interest paid on the loan was the debt which was located where the debtor, now a South African company, resides. However, none of the agreements relating to the debt were entered into in South Africa. The court held that the sale, which gave rise to the debt, occurred in England and not in South Africa. “*In determining the source of income it must first be determined what the source is from which the income is derived and when this has been determined, the place where that source is located must be ascertained. The source of income is not the quarter from which it comes but rather the originating cause of its receipt*”. It was thus held that the source of the interest received did not arise from a South African source. - *ibid*, *Income Tax Cases & Materials* 105-110

<sup>125</sup> *Transvaal Associated Hide and Skin Merchants v Collector of Income Tax, Botswana* 29 SATC 97 1967 (BCA) (hereinafter the “Transvaal Hide case”).

<sup>126</sup> *ibid*, *Income Tax Cases & Materials* 105

<sup>127</sup> 3 SATC 170 1928 AD 207

<sup>128</sup> *Commissioner of Taxes v W. Dunn & Co. Ltd* (1918, AD, 614)

<sup>129</sup> *ibid*

cannot be established, it would then be reasonable to apportion the income between the respective States involved.

A vital case with regards to apportionment is the South African case *Tuck v CIR*<sup>130</sup> (hereinafter the referred to as Tuck case), where Judge Corbett acknowledges the 'Dominant' cause, as held by Judge Watermeyer in the *Lever Bros* case, but goes further to acknowledge that it is possible for there to be two 'dominant' elements resulting in the *quid pro quo* arising.

In terms of the Tuck case, an employee received shares in 10 annual instalments upon retirement. The delivery of such shares was subject to the restraint of trade clause imposed upon the employee. However, the employee reflected the receipt of the instalments as relating half to the restraint of trade and the other half as the receipt of a lump sum received for compensation for the termination of services. Within SA tax legislation, the receipt of the lump sum at the time of the Tuck case met the definition of revenue and was taxable, and the amount received for the restraint of trade clause met the definition of capital and was not taxable. The SA Commissioner, dissatisfied that a portion of the amount was not taxable, disallowed the employee's assessment and assessed the employee for tax based on the entire amount received. Tuck, the employee, appealed to the Supreme Court of Appeal based on two main arguments, namely:

- i. *“That the casually relevant factor which resulted in the receipt of the shares was the taxpayer's compliance with the restraint agreement; and*
- ii. *Alternatively, that the receipt of the shares was attributable at least in part to the taxpayer's compliance with the restraint agreement and hence an apportionment of the receipt as between income and capital should take place”.*<sup>131</sup>

Tuck's contentions referred to Watermeyer's dictum as held in the *Lever Bros* case; i.e. *“that the source of receipts, received as income, is not the quarter whence they come, but the originating cause of their being received as income,*

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<sup>130</sup> 49 SATC 28 1988 (3) SA 819 (A) (hereinafter the “Tuck case”)

<sup>131</sup> *ibid*, *Income Tax Cases & Materials* 3ed (2001), 282

*and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo which he gives in return for which he received them*<sup>132</sup>. At the time of the Tuck case there was no South African tax case law precedent for the apportionment of an amount between capital and revenue. In holding judgment for this case, Judge Corbett utilised the ‘quid pro quo’ query – that is, what work did the taxpayer perform to earn the receipt of money received? However, one test in determining whether an amount is capital or revenue is the ‘Dominant Test’. The ‘Dominant Test’ relates to determining the ‘originating cause test’ as described above. The Tuck case gives rise to a differing school of principles and theory in that prior to Tuck, as per the CIR v Epstein case<sup>133</sup> (hereinafter referred to as Epstein case), the ‘dominant cause’ is utilised to determine taxing rights. However, in light of the dictum set in Tuck’s case, it would be interesting to revisit the Epstein case using the Tuck dictum to argue apportionment.

In terms of this paper, and the example utilised with regards to an E-commerce transaction, would one be able to utilise the ‘dominant cause’ test in determining the source and taxing rights on income arising? Or, alternatively, would apportionment be allowed or even be the best alternative? It should be borne in mind that should the ‘dominant cause’ test be utilised, how would it be determined which transaction gives rise to the ‘dominant cause’? In other words, how would one determine which transaction is worthy of being labelled the ‘dominant cause’, i.e. *“the source of receipts...[which is] the originating cause of their being received as income, and that this originating cause is the work which the taxpayer does to earn them, the quid pro quo ...”*<sup>134</sup>? If each transaction is

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<sup>132</sup> ibid 283

<sup>133</sup> Epstein, CIR v *19 SATC 221* 1954 (3) SA 689 (A)

Within the Epstein case the taxpayer was a South African resident and operating in Johannesburg. The taxpayer entered into a partnership agreement whereby all commodities exported by the taxpayer to Central and South America would be exported, exclusively, through the dealers with whom the taxpayer had entered into the partnership agreement with. The dealers in turn would either purchase the commodities themselves or, alternatively, dispose of the commodities on behalf of the taxpayer (i.e. they would act as agent). The profits arising from the sale of the commodities would be split 50:50. Despite the fact that the sales were only occurring in Central and South America, the South African Commissioner assessed the taxpayer on profits arising. The Commissioner acknowledged that the taxpayer carried on business through a partnership, however, it must be remembered that within South African legislation, each partner within a partnership is assessed and taxed on their share of profits arising from the partnership. Thus, in terms of the judgement, *“as all activities of the taxpayer took place in South Africa, the profits were derived from a source within South Africa”*. We are once again reminded of Watermeyer’s judgment in the :Lever Brothers case where it was held that *“the source of receipts, received as income, is not the quarter whence they come, but the 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”*. Ibid, *Income Tax Cases & Materials* 3ed (2001), 118-124, 105-110

<sup>134</sup> ibid 283

examined within the context of each State within which the respective transaction occurs it may indeed be difficult to determine the 'dominant cause' whereby the transaction in its entirety may be broken down into segments, so that should one transaction be removed from the chain, the other transactions would not be able to occur. For example, if one removes the accessing of the Amazon home page from the equation, the customer would not be able to purchase the 'movie'. Further, should one remove the 'Pay Now' segment of the transaction, the customer should not be able to purchase the 'movie'. In other words, where multiple ISP's are used, which ISP would be classified as the 'permanent establishment'? Thus, each segment within the transaction complements the other. Apportionment, while possibly a mathematical challenge, would undoubtedly resolve several issues and problems arising from E-commerce when determining 'source' and / or 'residence' of income, as each respective State would be entitled to a portion of the tax arising from the transaction. However, such a solution surely creates a new problem and issue of practicality and this difficulty has been highlighted by the OECD in that *"there [is] no universally agreed principles for dividing the tax pie between the source and residence countries, which makes it difficult to determine what is a "fair" allocation of taxing rights between these two countries"*<sup>135</sup>.

#### DETERMINING PERMANENT ESTABLISHMENT FOR 'SOURCE BASIS TAXATION'

As previously stated, 'permanent establishment' is a relevant concept within 'source' basis taxation. *"According to Article 7 of OECD Model, the source country may tax the profits arising from commercial activity carried out within its borders by a foreign entity through a substantial physical presence in the source country"*.<sup>136</sup> In order for this 'physical presence' to exist there must be a 'permanent establishment'. In order for the 'source' State to tax the profits on any business activity, the prerequisites of determining whether a 'permanent establishment' exists within the 'source' State, in terms of Article 7 of the OECD Model Convention, must be met, namely:

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<sup>135</sup> *ibid*, *E-commerce: Transfer Pricing and Business Profits Taxation*, 85

<sup>136</sup> Dr Jean-Philippe Chetcuti *The Challenge of E-commerce to the Definition of a Permanent Establishment: The OECD's Response* (2002). Available at <http://www.inter-lawyer.com/lex-e-scripta/articles/e-commerce-pe.htm> [Accessed 28 May 2008]

- i. There must be a distinct place of business within the 'source' country. Otherwise referred to as "PLACE-OF-BUSINESS TEST";
- ii. The business activities must be established and carried on with a certain degree of permanence. Otherwise referred to as the "PERMANENT TEST";  
**and**
- iii. The business activities within the 'source' State are carried on through the 'distinct place'. Otherwise referred to as the "BUSINESS-ACTIVITIES TEST".

If the 'physical presence' of the business activities does not meet all three of the requirements above, then there is no 'permanent establishment' and the 'source' State is not entitled to tax the profits on such an international transaction. Thus, in such a case, only the 'residence' State is entitled to tax the business profits.<sup>137</sup>

### **Double Tax Agreements and Taxing Principles as Applied by the OECD**

It is possible for the same business profits to be subject to competing tax claims by participating States due to "tax treaty rules [that] allow for business profits to be taxed by both the source and residence countries in some cases"<sup>138</sup>. In such instances, the competing tax claims are resolved by awarding taxing priority to the source country.<sup>139</sup> Furthermore, in terms of the OECD:

*"The question of the allocation of taxing rights over business profits may be divided in two separate, but intertwined, issues:*

- *in what circumstances should a country have a legitimate claim to tax the business profits of a foreign enterprise (i.e. the jurisdiction or nexus issue);*
- *what is the appropriate basis for deciding which part of the business profits of a foreign enterprise should be taxed in a country (i.e. the measurement of profits issue)."*<sup>140</sup>

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<sup>137</sup> *ibid*, *The Challenge of E-commerce to the Definition of a Permanent Establishment: The OECD's Response*

<sup>138</sup> *ibid*, *E-commerce: Transfer Pricing and Business Profits Taxation*, 80

<sup>139</sup> *ibid*

<sup>140</sup> *ibid*, 82

## CHAPTER FOUR

### E-COMMERCE & TAXATION

#### E-Commerce, the OECD and Suggested Solutions

##### E-COMMERCE AND THE OECD

*“The OECD view is that current domestic laws, double tax agreements and OECD rules and guidelines are basically adequate and effective in addressing any e-commerce challenge. The reality is however...that the internet will make the challenge much more complicated and difficult.”<sup>141</sup>*

The OECD, in response to the increasing e-Commerce problem, issued a Commentary Note on e-Commerce. The Commentary Notes falls under Article 5, Permanent Establishment, of the Model Convention.

The Committee on Fiscal Affairs<sup>142</sup> (hereinafter referred to as CFA) presented the OECD with the following tax principles regarding taxation of e-Commerce:

1. *“The taxation principles that guide governments in relation to conventional commerce should also guide them in relation to electronic commerce.*
2. *The CFA believes that existing taxation rules can implement these principles. This approach does not preclude new administrative or legislative measures, or changes to existing measures, relating to electronic commerce, provided that those measures are intended to assist in the application of the existing taxation principles, and are not intended to impose a discriminatory tax treatment of electronic commerce transactions.*
3. *The application of these principles to electronic commerce should be structured to maintain the fiscal sovereignty of countries, to achieve a fair sharing of the tax base from electronic commerce between countries and to avoid double and unintentional non-taxation.*
4. *The process of implementing these principles should involve and intensified dialogue with business and with non-member economies.”<sup>143</sup>*

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<sup>141</sup> *ibid*, *The International Taxation System*, 72

<sup>142</sup> As per the OECD website, Centre for Tax Policy and Administration: *“The Committee on Fiscal Affairs brings together senior officials from all OECD Member governments who play an active role in formulating and implementing tax policies. The Committee sets the OECD Work programme in the tax arena and provides a forum for exchanging views on tax policy and administrative issues. The detailed work of the Committee on Fiscal Affairs is carried out by a number of subsidiary groups of experts in particular areas, drawn from Member governments, and in certain cases, non-member economies. While most of the Committee’s work is undertaken by government officials and the OECD Secretariat, there is frequent consultation with representatives of business and trade unions and co-operation with other international and regional tax organisations.”* Available at [http://www.oecd.org/about/0,3347,en\\_2649\\_34897\\_1\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/about/0,3347,en_2649_34897_1_1_1_1_1,00.html) [Accessed 2 January 2009]

These principles were used to draw conclusions formulated in their 'Electronic Commerce: Taxation Framework Conditions'<sup>144</sup>: In brief, in defining 'source' in an e-Commerce environment, for purposes of taxation, one first applies the old / traditional tax principles as far as possible, however, should a difficulty arise, one should refer to the OECD Model Commentaries on e-Commerce.

The OECD Commentary Note relies on determining and defining 'Permanent Establishment' of e-Commerce transactions and trading in order to determine which State has the right to tax the business profits from such transactions.

The purpose, it has been suggested, for challenging and redefining the definition of 'Permanent Establishment' for purposes of e-Commerce, may be that while the enterprise may not have a physical presence, as is required by the traditional 'Permanent Establishment' definition, in a Contracting State and, therefore, does not physically benefit from the services provided by that State, the enterprise does, nevertheless, benefit *from the economy* of that State.<sup>145</sup> While the definition of 'Permanent Establishment' has not been redefined, as of yet, to incorporate a 'virtual presence'<sup>146</sup> within a State, there is, undoubtedly, support for such incorporation. However, to date, the OECD Commentary Note on E-commerce has found a means of testing for 'physical presence' by requiring a **server**, operated and controlled by the enterprise, to meet the definition of 'Permanent Establishment'.

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<sup>143</sup> OECD *Tax Administration Aspects of Electronic Commerce: Responding to the Challenges and Opportunities* (2001), 4. Available at <http://www.oecd.org/dataoecd/46/44/1923272.pdf> [Accessed 30 May 2008]

<sup>144</sup> OECD *Electronic Commerce: Taxation Framework Conditions, a Report by the Committee on Fiscal Affairs, as presented to Ministers at the OECD Ministerial Conference, "A Borderless World: Realising the Potential of Electronic Commerce" on 8 October 1998* (1998).

<sup>145</sup> *Ibid*, *E-commerce: Transfer Pricing and Business Profits Taxation* p92

<sup>146</sup> "The Concept of 'virtual PE' is a suggestion of an alternative nexus that would apply to e-commerce operations. This could be done in various ways, which would all require a modification of the permanent establishment definition (or the addition of a new nexus of rules in treaties)....

The "Virtual Fixed Place of Business PE" would create a permanent establishment when the enterprise maintains a web site on a server of another enterprise located in a jurisdiction and carries on business through that web site. The place of business is the web site, which is virtual....

... "On-site Business Presence PE" proposes a new threshold for source taxation which does not depend on the existence of a fixed place of business at the disposal of the enterprise or on the traditional view of a business activity taking place within a jurisdiction. Rather, it looks at the economic presence of an enterprise within a jurisdiction in circumstances where the foreign enterprise provides what the proponents of that approach view as on-site servers or other business interface... at the customer's location...

Clearly, therefore, the broadening of Article 5 to encompass Virtual Agent PEs would need to be accompanied by consequential changes to Article 7 in order to entertain the notion that profits could be attributable to virtual agents." *Ibid*, *E-commerce: Transfer Pricing and Business Profits Taxation* p144-146

The OECD Commentary makes the distinction between an Internet web site and a location where automated equipment is operated. It is important for the distinction to be made, as the Internet web site comprises a combination of software and electronic data which does not constitute 'tangible property'. In contrast, automated machinery operated by an enterprise may constitute 'tangible property' and, therefore, a 'Permanent Establishment', as the machinery is stored and operated at a 'physical location' which can be determined. Bearing this in mind, the argument is put forth that the server of the Internet web site may constitute a Permanent Establishment, as the server is a piece of equipment that has a 'physical location' which may be determined. However, in order to meet the definition and requirements of a 'Permanent Establishment', the computer equipment used by the server will "*need to be located at a certain place for a sufficient period of time so as to become fixed*",<sup>147, 148</sup>

However, within the technology world, it is possible for the enterprise that operates the Internet web site to be different from the enterprise that operates the server. In other words, an enterprise is capable of carrying on business through their web site while at the same time not necessarily operating the server. Thus, it is with this in mind, that the OECD Commentary Note proposes "*if the enterprise owns (or leases) and operates the server on which the web site is stored and used, the place where the server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met*"<sup>149</sup>. In other words; "*a [permanent establishment] may only arise where the server is at the disposal of the online enterprise who owns or leases it, and can never arise in the case of ISP hosting*"<sup>150</sup>.

In view of the above, the current rules for addressing the taxing of E-commerce transactions may be easily manipulated. The OECD Commentary deems an ISP to meet the definition of 'Permanent Establishment', however, only if operated and controlled by the enterprise. Thus, enterprises have several choices available to them to avoid meeting the definition of 'Permanent Establishment' in

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<sup>147</sup> *ibid*, *Electronic Commerce, Commentary Note on Article 5, Model Tax Convention on Income and Capital* 104

<sup>148</sup> *ibid*, *Electronic Commerce, Commentary Note on Article 5, Model Tax Convention on Income and Capital* 103-106

<sup>149</sup> *ibid* 104

<sup>150</sup> *ibid*, *The Challenge of E-commerce to the Definition of a Permanent Establishment: The OECD's Response*

jurisdiction of higher taxing rates. For example, in the Amazon example, if one were to assume that the entire 'movie' purchasing transaction occurred on only one server located in one country, Amazon could easily locate its server in the jurisdiction with a lower taxing rate, e.g. Ireland<sup>151</sup>. If, with modern Internet traffic, it became too unrealistic for Amazon to operate completely off one server, Amazon could go one step further and, while its server remained located in Ireland, it could have its web sites hosted by ISPs.<sup>152</sup> In such an instance, it would be irrelevant in which jurisdiction its web site hosting ISP was located, as such an ISP would not meet the definition of 'agent' and, therefore, would not create a 'Permanent Establishment' for Amazon. Thus, Amazon has been able to conduct business all over the world while only meeting the definition of 'Permanent Establishment' in one jurisdiction, the low-tax jurisdiction of Ireland. However, the Technical Advisory Group (hereinafter referred to as TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits<sup>153</sup>, countered this argument in their discussion draft on Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions by stating that "*to the extent that very little profits would be attributed to functions performed through a server or web site, such planning involving the location of servers and the hosting of web sites would have little consequences on tax revenues*"<sup>154</sup>.

#### THE OECD AND E-COMMERCE SUGGESTED SOLUTIONS

The quantity of suggested alternatives, which have been submitted to the OECD for consideration, are extensive and would comprise a paper on their own. As such, and for the purposes of this paper, the alternatives that would give rise to both non-fundamentally changing and fundamental changes in the taxing system will be briefly explored and, as listed by the OECD, consist of the following:

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<sup>151</sup> Ireland currently (2008) has a flat corporate tax rate of 12.5 per cent compared to countries such as Netherlands with tax rates varying from 20 per cent to 23.5 per cent, New Zealand's flat rate of 30 per cent, United States of America's tax rates varying from 15 per cent to 35 per cent, etc. Tax rate information obtained from the PriceWater House Coopers Worldwide Tax Summaries website available at <http://www.taxsummaries.pwc.com/uk/wwts/wwts.nsf?Open> [Accessed 28 December 2008]

<sup>152</sup> *ibid*, *E-commerce: Transfer Pricing and Business Profits Taxation* p94

<sup>153</sup> "The Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits was set up by the OECD Committee on Fiscal Affairs in January 1999 with the general mandate to "examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce and examine proposals for alternative rules". *Ibid*, *E-commerce: Transfer Pricing and Business Profits Taxation* p71

<sup>154</sup> *ibid* 94

1. *“Changes that would not require a fundamental modification of the existing rules*
  - 1.1. *Modification of the permanent establishment definition to exclude activities that do not involve human intervention by personnel, including dependent agent;*
  - 1.2. *Modification of the permanent establishment definition to provide that server cannot, in itself, constitute a permanent establishment;*
  - 1.3. *Modification of the permanent establishment definition / interpretation to exclude functions attributable to software when applying the preparatory or auxiliary exception;*
  - 1.4. *Elimination of the existing exceptions in paragraph 4 of Article 5 or making these exceptions subject to the overall condition that they be preparatory or auxiliary;*
  - 1.5. *Elimination of the exceptions for storage, display or delivery in paragraph 4 of Article 5;*
  - 1.6. *Modification of the existing rules to add a force-of-attraction rule dealing with e-commerce;*
  - 1.7. *Adopting supplementary nexus rules for purposes of taxing profits arising from the provision of services*
2. *Changes that would require a fundamental modification of the existing rules*
  - 2.1. *Adopting rules similar to those concerning taxation of passive income to allow source taxation of payments related to some forms of e-commerce (so as to subject them to source withholding tax);*
  - 2.2. *A new nexus: base eroding payments arising in a country;*
  - 2.3. *Replacing separate entity accounting and arm’s length by formulary apportionment of profits of a common group*
  - 2.4. *Adding a new nexus of “electronic (virtual) permanent establishment”*.<sup>155</sup>

### **E-Commerce – Problems facing the tax world**

E-commerce, for tax purposes, encompasses a variety of problems and issues, whether currently in existence, or potentially possible as technology further develops and e-commerce expands. The issues and problems facing the tax world in relation to E-commerce, as set out herein, should not be viewed and read as the only problems existing, but rather as a demonstration of the extent of the problems created as a result of E-commerce being introduced and operating in a traditional taxing environment.

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<sup>155</sup> *ibid*, *E-Commerce: Transfer Pricing and Business Profits Taxation* p105-150

An argued flaw of the OECD's position, with regards to defining 'source' for purposes of taxation, is that "*it ignores the possibility of e-Commerce functions being transferred to the end consumer's computer*"<sup>156</sup>. The possibility of e-Commerce functions being transferred to the end consumer's computer may have an adverse affect on the defining of Permanent Establishment, should the taxpayer meet the requirements of 'Permanent Establishment' as defined by the OECD Commentary.

Another debatable topic is whether it makes sense to define 'Permanent Establishment' within the context of electronic commerce? "*At a fundamental level, one can argue that it makes little sense to attempt to fine-tune a definition of permanent establishment, rooted in concepts of physical presence, for a universe of transactions in which physical presence is often irrelevant. In fact the OECD itself has recognized these concerns by mandating its Technical Assistance Group on Monitoring the Application of Existing Norms for Taxation of Business*"<sup>157</sup>. Such an argued flaw relates back to the proposed alternative of adding "Electronic (virtual) Permanent Establishment" as a new nexus in order to overcome this flawed definition.<sup>158</sup>

Furthermore, transfer pricing<sup>159</sup> guidelines, as set out by the OECD, may be inadequate when applied to the E-commerce environment. E-commerce may give rise to tax administrations experiencing greater difficulties in identifying, tracing and quantifying cross-border transactions for purposes of determining transfer pricing. The OECD have identified and acknowledged this as an area of concern, arising not as a result of new or categorically different problems being created by E-commerce, but rather that the "*emergence and growth of electronic commerce will potentially make some of the more difficult transfer pricing problems more common*"<sup>160 161</sup>. The concept and issues relating to Transfer Pricing

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<sup>156</sup> *ibid*, *The Challenge of E-commerce to the definition of a Permanent Establishment: The OECD's Response*, 9

<sup>157</sup> Walter Hellerstein *Electronic Commerce and the Challenge for Tax Administration* (2002), 11. Available at [http://www.wto.org/english/tratop\\_e/devel\\_e/sem05\\_e/hellerstein.doc](http://www.wto.org/english/tratop_e/devel_e/sem05_e/hellerstein.doc). [Accessed 21 April 2008]

<sup>158</sup> Listed above under "The OECD and E-Commerce Suggested Solutions"

<sup>159</sup> Transfer Pricing, as defined by Arnold & McIntyre *International Tax Primer 2002* 55, is: "*A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related person. For example, if ACo manufactures goods in Country A and sells them to its foreign affiliate, BCo, organised in Country B, the price at which that sale takes place is called a transfer price. A transfer price is usually contrasted with a market price, which is the price set in the market place for transfers of goods and services between unrelated persons.*" *Ibid*, *International Tax A South African Perspective 2008* 484

<sup>160</sup> *ibid*, *E-Commerce: Transfer Pricing and Business Profits Taxation* 58

in E-commerce environment will not be explored any further for purposes of this paper, as it comprises a separate issue and falls outside the ambit of this paper and was merely mentioned to illustrate the extent of problems and issues facing the taxing world in relation to E-commerce.

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<sup>161</sup> *ibid*

## CHAPTER FIVE

### CONCLUSION

E-commerce growth rates in the United Kingdom, since its base lining of 100 in April 2000, was projected at 3,500 by the end of 2006.<sup>162</sup> The purpose of illustrating E-commerce's growth is to emphasize the eminent "*significant decrease to the tax revenues of capital importing countries*"<sup>163</sup>. While E-commerce may be within its early infancy of development and implementation, its growth has been exponential compared to that of the radio and television. Demonstrating this point with the use of statistics: "*To reach 50 million users, it took 38 years for radio, 13 years for television and 4 years for the Internet*"<sup>164</sup>.

Extensive alternative solutions to taxing E-commerce transactions have been submitted to and compiled by TAG, and in reaching their conclusion with regards to the best manner in which to define 'source' and determine taxing rights for purposes of revenue arising from E-commerce transactions, the following was stated:

*"As regards the various alternatives for fundamental changes that are discussed...the TAG concluded that it would not be appropriate to embark on such changes at this time. Indeed, at this stage, E-commerce and other business models resulting from new communication technologies would not, by themselves, justify a dramatic departure from the current rules. Contrary to early predictions, there does not seem to be actual evidence that the communications efficiencies of the internet have caused any significant decrease to the tax revenues of capital importing countries"*<sup>165</sup>.

When devising a solution to a problem, one should be mindful that the administration costs expended in resolving the matter and, furthermore, the cost expended in implementing the collection of taxes, should not exceed the tax benefit received in return. TAG may well be correct in stating that there currently does not appear "*to be actual evidence that the communication efficiencies of the*

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<sup>162</sup> DaveChaffey.com: Your Guide to Digital Business *E-Commerce growth rates UK*. Available at <http://www.davechaffey.com/E-business/C1-Introduction/E-commerce-growth-rates-UK> [Accessed 28/12/2008]

<sup>163</sup> *ibid E-commerce: Transfer Pricing and Business Profits Taxation* 151

<sup>164</sup> Annette Nellen et al *Overview to E-Commerce Taxation – Guide to Understanding the Current Discussions and Debates* (July 2003) 8. Available at [www.cob.sjsu.edu/facstaff/NELLEN\\_A/ECOMM.pdf](http://www.cob.sjsu.edu/facstaff/NELLEN_A/ECOMM.pdf) [Accessed 24/12/2008]

<sup>165</sup> *ibid, E-commerce: Transfer Pricing and Business Profits Taxation* 151

*Internet have caused any significant decrease to the tax revenues...*"<sup>166</sup>. However, this does not imply that such "*decrease to...tax revenues...*" will never occur. Indeed, a decrease in tax revenues may be expected based on the rapid growth rate of E-commerce as illustrated above. Further, it would appear that based on the recommendation of TAG, the OECD is assuming the approach of: "We'll cross that bridge when we come to it!"

This may not be an unrealistic approach to follow as one should also bear in mind that by the time E-commerce does in fact result in "*decrease to...tax revenues of capital importing countries*", there may very well be new technology available to tax authorities in order to assist with the collection of tax arising from E-commerce. What would be the purpose of devising a solution to a future technology problem based on current methods and technology? Thus, for current purposes, it appears that the preferred approach and the possible approach for determining "source" of revenue for taxing purposes is based on the application of traditional tax principles followed by simplistic recommendations as set out in the OECD Commentary.

Applying the correct principles to E-commerce appears, as a result of international debates and arguments over rightful entitlement, to be the challenge. The application of applicable taxing principles may reduce squabbles caused by the varying definitions of different countries. For example, the application of "Dominant Cause" may very well be the easiest way to resolve taxing rights, and determine the "source" of income derived from E-commerce transactions. However, the definition of "Dominant Cause" may vary so drastically between two countries as to result in each of those two countries insisting that it has the sole taxing right. With this in mind we may observe the importance of not only applying the correct and applicable taxing principles, but also the importance of strong international co-operation through the use of Double Taxation Agreements.

As set out within this paper, to determine "source" within an E-commerce environment the following tests would need to be applied in attempting to reach a conclusive answer in relation to determining "source" for taxing purposes:

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<sup>166</sup> ibid

- i. Determining the ‘originating cause’ giving rise to the generating of income<sup>167</sup>
- ii. Determining the ‘dominant cause’ where there are two or more ‘originating cause’s<sup>168</sup>
- iii. Application of Permanent Establishment definition
- iv. Application of the OECD commentary defining Permanent Establishment for E-commerce
- v. Determining apportionment<sup>169</sup> of profits.

The need for applying that above tests is necessary because different countries may each believe that it is entitled to the tax revenue generated from a transaction. While Amazon may be a “resident” of California, USA, for tax purposes, as it is there that Amazon is incorporated and registered, the fact that Amazon owns a server on which the USA web site is hosted will also give rise to “source” based taxation. Keeping in mind that the other countries involved may view the source of income as arising within their borders as well, the application of the above steps, to the Amazon example, may assist in determining the “source” of income for tax purposes:

***1. Can the “originating cause” be determined for purpose of determining “source” of income?***

In terms of the Amazon example, it may be difficult to determine the “originating cause” as each country involved may feel that the transaction occurring within its ‘virtual borders’ is the ‘originating cause’ of the generated income. Further, it may also be difficult to determine ‘dominant cause’ at this juncture. This does not, however, bring one to a stale mate in resolving this matter, as one may proceed to determining ‘permanent establishment’ of Amazon and return to ‘dominant cause’ at a later stage.

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<sup>167</sup> *ibid*, Lever Brothers case

<sup>168</sup> *ibid*, Transvaal Hide case

<sup>169</sup> *ibid*, Tuck case

**2. *Where is Amazon's 'Permanent Establishment' for purposes of this E-commerce transaction?***

Due to the quantity of transactions occurring over several countries in relation to this E-commerce transaction, it may not be possible to apply the traditional 'Permanent Establishment' tests, and assistance may be needed from the OECD Commentary on E-commerce. It should be borne in mind that in terms of the definition of 'permanent establishment' the enterprise is required to 'have a place of business which is fixed and where the enterprise is carried on through this fixed place of business'? Thus, applying the traditional 'permanent establishment' requirements in conjunction with the OECD Commentary on E-commerce, one may be able to eliminate some transactions in determining the 'source' of the revenue. As mentioned, the OECD allows for an ISP to meet the definition of 'permanent establishment', providing that the ISP is owned and controlled by the company, namely Amazon, and its web page is not merely hosted on the ISP. Assuming here that Amazon only owns the ISP in California, USA, London, United Kingdom and Hong Kong, China, one would be able to eliminate the following cities and countries in determining the 'source' of income generated: New York, USA; Berlin, Germany; Cape Town, South Africa; Johannesburg, South Africa; and Geneva, Switzerland.

**3. *Reapplying the "originating cause" and "dominant cause" principles to the remaining three countries involved in this E-commerce transaction***

It may, nevertheless, be difficult to determine the "originating cause" as argument may be made for each remaining segment of the transaction; i.e. what actually gives rise to the income generated? Is it the accessing of the Amazon web site, is it the payment for the right to download the movie or is it the actual downloading of the movie?

Based on this analogy, there may be strong argument for the "dominant cause" to lie where the 'contract was concluded', for example, London, United Kingdom, as in terms of the Lever Brothers case. However, if one examines the transaction based on the binding obligation of the contract between the customer and Amazon, one may find "source" to mean

“not a legal concept but something which a practical man would regard as a real source of income”<sup>170</sup>. If Amazon does not deliver in terms of the sale contract, the customer, that is, the ‘practical’ man, would most likely take legal action against Amazon in California, USA as that is the Amazon location that the customer was under the impression he was dealing with all along. The issue that arises here is the application of “something which a practical man would regard as a real source of income”<sup>171</sup>, as such an analogy may lead one away from determining “dominant source” because all three countries may claim “originating cause”. In other words, in applying a practical meaning, each country may view their contribution as the “originating cause” or an apportionment of the originating cause.

**4. What recourse is left should all three locations be deemed to be the “source” of the income generated?**

The last option available would be “apportionment”, in terms of the authority laid down in the Tuck case, of the profit generated from the sale of the movie between all three countries.

While the mathematical apportionment of the revenue generated may be difficult and at times impractical, it may be, through the application of traditional taxing principles applied in conjunction with the OECD Commentary on E-commerce, possible to determine the “source” of the revenue generated from an E-commerce transaction.

Understanding and exploring the concepts of ‘source’ and ‘International Taxation’ within and out of an e-Commerce environment is necessary in determining ‘who is entitled to the taxation on such trading’ and in determining ways to tax International Trading. While “*the Internet is an important cultural phenomenon...[it has nevertheless] failed to comply with basic economic laws...[as] it was devised by a bunch of hippie anarchists*”<sup>172</sup>. Taxation is an integral part of human history, past and present, and while, “*the best things in life are free... sooner or later the government will find a way to tax them*”<sup>173</sup>!

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<sup>170</sup> Rhodesia Metals Ltd (In Liquidation) v COT 1940 AC 774 at 789, 1940 AD 432 at 436

<sup>171</sup> Commissioner of Tax v British United Shoe Machinery (SA) (Pty) Ltd 26 SATC 163

<sup>172</sup> Thomas Nolle. Available at [www.quoteagarden.com/internet.html](http://www.quoteagarden.com/internet.html) [Accessed 8 May 2008]

<sup>173</sup> Anonymous. Available at <http://www.quoteagarden.com/taxes.html> [Accessed 8 May 2008]

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# VAT IMPLICATIONS IN E-COMMERCE FROM A SOUTH AFRICAN PERSPECTIVE

[DISSERTATION TWO OF TWO]

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

## PREFACE

The primary focus of this paper is to assess the interpretation and application of South African Value-Added Tax legislation with regard to E-commerce cross-border transactions. The relationship between the current South African legislation and recommended proposals by the Organisation for Economic Co-ordination and Development, as well as New Zealand's Value-Added Tax legislation and proposals in relation to E-commerce and imposition of Value-added Tax thereon is also examined.

In 1991 South Africa adopted, predominantly, the New Zealand Value-added Tax legislation and therefore, the New Zealand Value-Added Tax legislation will be discussed.

January 2009  
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## CHAPTER ONE

### INTRODUCTION

This paper leads on from the first paper, “International Taxation and Domestic Taxation: Defining ‘Source’ within and out of an E-Commerce Environment”<sup>1</sup>. Whilst the first paper focused primarily on international aspects of e-commerce and taxation, this paper will focus more on South African domestic tax legislation with regards to Value-Added Taxation (hereinafter referred to as VAT) in an E-commerce environment. While exploring VAT, the famous sentence of Alan Tait should be borne in mind:

*“...the VAT may be thought of as the Mata Hari of the tax world – many are tempted, many succumb, some tremble on the brink, while others leave only to return, eventually the attraction appears irresistible”<sup>2</sup>*

### THE HISTORY OF VALUE-ADDED TAXATION

The concept of VAT was first devised in Germany post-World War I. Prior to the introduction of VAT, a “*cascading turnover tax was imposed every time... goods were transferred in the process of production and distribution to the consumer*”<sup>3</sup>. Dr Wilhelm von Siemens, upon recognizing the problems with the existing Turnover Taxes, devised a new taxing system. A major flaw, or so it was believed, with the Turnover Taxes was that it was “cascading”. Simply put, “*cascading taxes cannot be reclaimed by the purchaser, so that the tax component of the price of goods becomes larger and larger the more stages there are between producer and consumer – with obvious distortionary effects as between highly integrated enterprises and other enterprises*”<sup>4</sup>. France extended this ‘new taxing

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<sup>1</sup> Anne Bardopoulos et al *International Taxation & Domestic Taxation: Defining ‘Source’ within and out of an E-commerce Environment*.

<sup>2</sup> Alan Tait et al *Value Added Tax: International Practice and Problems* International Monetary Fund (1988). Also, New York School of Law, *Value Added Taxation of Electronic Supply of Services*, Tait, Alan. Available at <http://www.jeanmonnetprogram.org/papers/01/013301-02.html> [Accessed 9 August 2008].

<sup>3</sup> Alan Schenk & Oliver Oldman et al *Value Added Tax A Comparative Approach* Cambridge University Press. Available at [http://assets.cambridge.org/97805218/51121/excerpt/978052181121\\_excerpt.pdf](http://assets.cambridge.org/97805218/51121/excerpt/978052181121_excerpt.pdf) [Accessed 12/08/2008]

<sup>4</sup> *ibid*

system' in 1954. This 'new extended' version of the 'new taxing system' was fondly labelled "value added tax".<sup>5</sup>

The "rapid rise of the value-added taxation", since its introduction, has been described as "*the most dramatic - and probably most important - development in taxation in the latter part of the twentieth century, and it still continues*"<sup>6</sup>. This "rapid rise" flourished between the years 1987 to 1997, with many eastern European, Asian countries and former Soviet republics introducing VAT to their taxing system.<sup>7</sup>

The European VAT system even immigrated to New Zealand in 1985. However, New Zealand implemented VAT with a much broader taxing base than elsewhere. It may be said that New Zealand, in effect, adopted the European VAT system and removed all the known imperfections. South Africa adopted the New Zealand VAT system with effective date 30 September 1991. Canada implemented their VAT system in the same year as South Africa; however, Canada's VAT system required adjusting to take into consideration supplies made on a reserve<sup>8</sup> to Native Indians. Japan implemented VAT in 1989. It should be noted that Japan's VAT system is in fact different from other VAT systems, and this will be discussed later.<sup>9</sup>

To date, more than 130 countries worldwide have introduced VAT into their national taxing system compared to the late 1960's when less than ten countries had adopted the VAT system.<sup>10</sup> In fact, the United States of America (hereinafter referred to as USA) remains one of the few industrialised countries that has not

<sup>5</sup> Michael Keen et al *IMF Working Paper, VAT Attacks!* International Monetary Fund (2007) Introduction, 3. Available at <http://www.imf.org/external/pubs/ft/wp/2007/wp07142.pdf> [Accessed 12/08/2008]

<sup>6</sup> Liam Ebrill *Finance and Development*, quoted in Wendy H. Mason et al *Value-Added Tax – The VAT Assessment Process, History of Value-Added Tax*. Available at <http://www.referenceforbusiness.com/management/Tr-Z/Value-Added-Tax.html> [Accessed 12/08/2008]

<sup>7</sup> Wendy H. Mason et al *Value-Added Tax – The VAT Assessment Process, History of Value-Added Tax*. Available at <http://www.referenceforbusiness.com/management/Tr-Z/Value-Added-Tax.html> [Accessed 12/08/2008]

<sup>8</sup> A 'reserve' is land over which a First Nation Indian band (Canadian Native Nations) exercises governmental control and where taxable supplies are made on such land, to an Indian, those supplies will not be subject to the Canadian type VAT; i.e. Goods and Services Tax. It may be of interest to note that "*several band councils or other governing bodies of a First Nation adopted the First Nation GST (FNGST) [Goods and Services Tax]. The FNGST is comparable to the Canadian GST... Where enacted, the FNGST, not the Canadian GST, applies to taxable supplies on First Nation lands*". Ibid, *Value Added Tax A Comparative Approach* 19

<sup>9</sup> *ibid*, *Value Added Tax A Comparative Approach* 18

<sup>10</sup> OECD *Consumption Tax Trends, VAT/GST and Excise Rates, Trends and Administration Issues* (hereinafter referred to as "OECD Consumption Tax") OECD Publishers (2006) 18 & 92

adopted VAT.<sup>11</sup> Currently there are only two USA States which have adopted some form of VAT while the rest of the USA consists of “a patchwork of retail sales taxes”<sup>12</sup> (retails sales tax discussed below)<sup>13</sup>. As the retail sales tax is imposed by each state and is not a Federal tax, there are in fact forty-six different types of retail sales taxes. In terms of current USA legislation, as a sales tax is imposed in each State and is based on the destination principle, a seller located in, say, New York cannot be required to collect retail sales tax on an item sold if the good is to be consumed in, say, California unless the New York seller has a physical presence in California.<sup>14</sup> The intricate sales tax system of the USA is a paper on its own and, therefore, will not be discussed any further for the purpose of this paper.

### WHAT EXACTLY IS VAT?

VAT, an indirect tax, is levied at each step of the production and distribution process, that is when the product is sold or whenever “value is added” to the product. This tax is passed from the manufacturer, to the distributor, to the consumer, so that the end user, in effect, bears the cost of the tax. For this principle to work, the manufacturer will incur VAT expense when purchasing the raw materials, which then will be passed onto the distributor by including this VAT in the selling price. The manufacturer in turn claims the VAT expense incurred on the acquisition of raw materials back from the government. This process continues until the end consumer, who will pay VAT on the product purchased but will not be able to claim any VAT back from the government.<sup>15</sup> VAT spreads the collection and imposition of the sales tax throughout the entire production and distribution line. In other words, it is a tax levied at all stages even though it is a consumption tax. The concept behind VAT is that while the tax is levied at each stage, the business acquiring the goods for further production or sale is entitled to claim the tax back as a credit. Thus, the burden of the tax is passed onto the end consumer, but the government is able to collect the tax in stages rather than all at once at the end. The main reason for the imposition of

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<sup>11</sup> *ibid*, *Value Added Tax A Comparative Approach* 19

<sup>12</sup> *ibid* 395

<sup>13</sup> Retail Sales Tax is discussed in this paper under “VAT in South Africa”, however, in brief, retail sales tax is otherwise referred to as a single stage retail sales tax. The retail sales tax is where all the tax is collected at a single stage. The ‘single stage’ is the final point of distribution to the customer.

<sup>14</sup> *ibid*, *Value Added Tax A Comparative Approach* 395 - 405

<sup>15</sup> *ibid*, *Value-Added Tax – The VAT Assessment Process, History of Value-Added Tax*.

VAT is that “VAT is the greater ease of enforcement and thus less risk of evasion”<sup>16, 17</sup>.

As previously stated, VAT is an indirect tax. Taxes customarily fall into two different categories, that is, either “direct taxes” or “indirect taxes”. American Law, as defined by Alan Schenk, has provided a comparative explanation of the two types of tax categories as follows:

*“A direct tax is one that is assessed upon the property, business or income of the individual who is to pay the tax. Conversely indirect taxes are taxes that are levied upon commodities before they reach the consumer who ultimately pay[s] the taxes as part of the market price of the commodity”.*<sup>18</sup>

In other words, “indirect taxes” are taxes levied on goods and services consumed by the taxpayer whereby the end user bears the brunt of the tax as it is a ‘consumption tax’. This consumption tax may take the form of “a single-stage tax like the retail sales tax or a multistage tax like a value-added tax”<sup>19</sup>. The multistage tax, and especially the consumption tax known as VAT, will remain the primary focus of this paper. For purposes of this paper, the term “indirect taxes” and “VAT” may be used interchangeably for the multistage tax. It should, furthermore, be noted that while some countries utilise the term VAT other countries utilise the term Goods and Services Tax (hereinafter referred to as GST). VAT and GST are in fact the same thing and may also be used interchangeably.

There are four commonly known methods of imposing and implementing the multistage tax known as VAT. In short there is an “addition method”, a “sales-subtraction method” and two different types of “credit-subtraction methods”. Each method will be briefly examined:

#### **i. The sales-subtraction method**

The sales-subtraction method is not a tax imposed on individual transactions. Instead the seller is required to include VAT on the sale of all goods and

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<sup>16</sup> *ibid*, 1-6

<sup>17</sup> *ibid*, 1-5 – 1-6

<sup>18</sup> *Ibid*, *Value Added Tax: A Comparative Approach* 5

<sup>19</sup> *ibid* 30

services and at the end of each VAT period “cumulative data” is compiled based on sales for the period. This “cumulative data” is utilised to calculate the VAT liability for the period. The manner in which VAT is calculated under this method does not allow for easy imposition of more than one VAT rate and is, as a result, restrictive.<sup>20</sup>

**ii. Credit-subtraction method otherwise referred to as the “Credit-Invoice VAT”**

Determination of VAT liability for a VAT period in terms of the credit-subtraction method is simply the taxable supplies multiplied by the VAT rate less taxable purchases multiplied by the VAT rate.<sup>21</sup> The “Credit-Invoice VAT” may be the most utilised and implemented VAT system. The “Credit-Invoice VAT” method is the European style VAT. This method relies on the use of invoices. A good description of the European Style VAT, as summarised by Alan Schenk, is that “*the EU<sup>22</sup>-style VAT reaches international transactions under the destination principle, imposes tax on a consumption base, and typically calculates output tax on tax-exclusive prices*”<sup>23</sup>. While this is the most commonly used VAT method, flaws exist within this method, as it is unable to easily handle some industries and transactions when calculating and imposing VAT.<sup>24</sup>

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<sup>20</sup> *ibid*, Value Added Tax: A Comparative Approach 42

<sup>21</sup> *ibid*, Value Added Tax A Comparative Approach 39

<sup>22</sup> EU is the abbreviation for European Union. A brief history of the EU, as provided by Europa, The History of the European Union. Available at [http://europa.eu/abc/history/index\\_en.htm](http://europa.eu/abc/history/index_en.htm) [Accessed 4 January 2009]: “The European Union is set up with the aim of ending the frequent and bloody wars between neighbours, which culminated in the Second World War. As of 1950, the European Coal and Steel Community begins to unite European countries economically and politically in order to secure lasting peace. The six founders are Belgium, France, Germany, Italy, Luxembourg and the Netherlands. The 1950s are dominated by a cold war between east and west. Protests in Hungary against the Communist regime are put down by Soviet tanks in 1956; while the following year, 1957, the Soviet Union takes the lead in the space race, when it launches the first man-made space satellite, Sputnik 1. Also in 1957, the Treaty of Rome creates the European Economic Community (EEC), or ‘Common Market’... With the collapse of communism across central and eastern Europe, Europeans become closer neighbours. In 1993 the Single Market is completed with the ‘four freedoms’ of: movement of goods, services, people and money... Communication is made easier as more and more people start using mobile phones and the internet... [1 January 1993] The single market and its four freedoms are established: the free movement of goods, services, people and money is now reality. More than 200 laws have been agreed since 1986 covering tax policy, business regulations, professional qualifications and other barriers to open frontiers...”

<sup>23</sup> *ibid* 39

<sup>24</sup> *ibid* 40

### iii. The Credit-subtraction Method without Invoices

VAT liability in terms of the credit-subtraction method without invoices is determined in the same way as the credit-subtraction method with invoices, except businesses are not required to issue tax invoices and VAT registered businesses are entitled to claim VAT on taxable supplies acquired from non-registered businesses.<sup>25</sup> The Credit-subtraction Method without Invoices is calculated and determined similarly to the Credit-subtraction method with Invoice, except businesses are not required to issue VAT invoices on taxable sales. This method is otherwise referred to as the Japanese-style VAT.<sup>26</sup>

### iv. Addition-Method VAT

It should be noted that except for Israel's indirect taxing of financial institutions and insurance companies, the Addition-Method VAT has not been implemented by any country as a national tax.<sup>27</sup> VAT is determined within this method by determining the company's 'economic factors' relating to production for a period and multiplying it by the tax rate. In other words, the company's "*wages, rent and interest expenses, and profit for VAT purposes*"<sup>28</sup> is determined and then multiplied by the tax rate to determine the company's VAT liability for a period.<sup>29</sup>

While there may be different methods of imposing VAT it is, nevertheless, essential that "shared basic principles" exist between the different countries utilising the multi-stage sales tax system. The need for these "shared basic principles" arises as a result of increased globalisation and international trading, thus in turn giving rise for the need for countries to work together in order to "*prevent double taxation, involuntary non-taxation, tax evasion and distortion of competition*"<sup>30</sup>. The Organisation for Economic Co-operation and Development (hereinafter referred to as OECD) have set out desirable factors required to allow for tax authorities around the

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<sup>25</sup> *ibid*, *Value Added Tax A Comparative Approach* 41

<sup>26</sup> *ibid* 41

<sup>27</sup> *ibid* 43

<sup>28</sup> *ibid* 42

<sup>29</sup> *ibid*

<sup>30</sup> *ibid*, *OECD Consumption Tax* 24

world to manage tax imposition and collection more efficiently. These factors are listed below:<sup>31</sup>

- *“a broad base at the standard rate;*
- *minimal exemptions and reduced rates;*
- *a registration threshold that allows tax administration to concentrate on core significant taxpayers”*<sup>32</sup>

While there are four commonly known methods of imposing VAT, a country may not only implement any one of the four above mentioned methods, but may further utilise a “single-tier” VAT rate or a “multiple-tier” VAT rate. A “single-tier” VAT rate is when only one tax rate is imposed, for example, a standard rate of fourteen per cent. The “multiple-tier” VAT rate is when there are several VAT rates imposed on different items and categories of goods and services within the market. For example, Sweden<sup>33</sup> has a general VAT rate of twenty five per cent on their goods and services, twelve per cent on a variety of goods and services including foodstuffs and letting of rooms in hotels, and six per cent on a further variety of goods and services including travelling expenses and books.<sup>34</sup> It should be noted that the reduction or even elimination of multi-tier VAT rates has also been identified by the OECD as an area which may give rise to reduced tax management efficiency problems. The use of multi-tier VAT rates gives rise to increased compliance and enforcement costs and, furthermore, creates legal uncertainty as well as increased fraud occurrences.<sup>35</sup> The question arises that if multi-tier VAT rates gives rise to such problems, what is the reasoning behind the implantation of multi-tier VAT rates? There is a school of thought that multi-tier VAT rates promote equity within the economy. In the words of the OECD, *“it is considered desirable to alleviate the tax on goods and services that form a larger share of expenditure of the poorest households”*<sup>36</sup>. However, the validity of this reasoning has been questioned and a counter school of thought exists in relation to this theory. While the objective of

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<sup>31</sup> *ibid*

<sup>32</sup> *ibid*

<sup>33</sup> The Swedish Tax Authority is known as the “Skatteverket”

<sup>34</sup> Skatteverket *SKV 552B Edition 9: The VAT Brochure*. Available at <http://www.skatteverket.se/download/18.2132aba31199fa6713e800013050/552B09.pdf> [Accessed 7/01/2009]

<sup>35</sup> *ibid*, 39

<sup>36</sup> *ibid*

imposing lower VAT rates on more commonly consumed goods is to benefit the poorer households, the wealthier households will also benefit from the lower VAT rate. For example, if a lower VAT rate is imposed on milk, being considered a food necessity, both poor and wealthy houses will consume VAT reduced milk, thereby resulting in both households enjoying the benefit of a lower VAT rate. Thus, can one really argue that the poorer household is benefiting? In rebutting this benefit validity, it is argued that the poorer households benefit as higher VAT rates are placed on goods and services considered 'luxurious', and as such will only be consumed by the wealthier households, thereby proportionately spreading out the tax burden on society. However, in terms of the OECD, "*using VAT...rates to meet social objectives may not always be the most efficient way of ensuring that those who need assistance actually receive it*"<sup>37</sup>.

The OECD have identified three factors that will, if interacted with each other, dictate the performance of a VAT system implemented in a country:

1. *The structural features of the tax, i.e. rates, exemptions, bases and thresholds.*
2. *The capacity of the tax administration to manage the system in an efficient way.*
3. *The degree of compliance of taxpayers.*"<sup>38</sup>

### VAT IN SOUTH AFRICA

It is important to understand the political and economic environment of South Africa at the time of the introduction of VAT. "*All developing countries face difficult problems in trying to marshal limited resources to promote economic growth. Few face a combination of problems as challenging as those confronting South Africa.*"<sup>39</sup>

Due to the favourable gold prices during the 1970's and early 1980's, the South African government enjoyed surplus budgets. However, the financial years of

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<sup>37</sup> *ibid*

<sup>38</sup> *ibid*, 42

<sup>39</sup> Henry J. Aaron *The South African Tax System: A Nation in Microcosm* Brookings (1999). Available at [http://www.brookings.edu/articles/1999/1206africa\\_aaron.aspx](http://www.brookings.edu/articles/1999/1206africa_aaron.aspx) [Accessed 13/08/2008]

1990 and 1991 experienced a severe decline in the gold price and, therefore, the tax revenues. In fact, the total tax revenues as a result of gold declined from twenty five per cent down to two per cent. The South African government, in an attempt to meet the shortfall in the budget resulting from a declining gold price, relied on deficit financing rather than increasing the tax rates on businesses. By 1991 the South African government decided to explore a new approach to filling the government's coffers – VAT. The aim of introducing VAT was to enable the government to “increase its revenues by “widening the net” of goods and services tax”<sup>40</sup>. Thus the former general sales tax of thirteen per cent was replaced with a ten per cent VAT.<sup>41</sup> South Africa based this new VAT legislation on New Zealand's VAT legislation. The reason why South Africa opted to utilise the New Zealand VAT legislation as the basis for implementing VAT in South Africa, was due to the fact that New Zealand had imposed a VAT system that had “a wide tax base with very few exceptions”<sup>42</sup>.

While the introduction of VAT may have been viewed as a solution for the South African government to fill its coffers without having to increase business taxes, protests to the introduction of VAT were led by the working masses who argued that this new tax “disproportionately [hurt] the poor”<sup>43</sup>. A mass strike was organised by the unions in protest to the introduction and implementation of VAT into the South African economy. The African National Congress and the Congress of South African Trade Unions released a joint statement with regards to the matter stating, “the only sensible course for the Government to take is to freeze further implementation of VAT and accept the need to negotiate with the entire spectrum of South African society on the issue”<sup>44 45</sup>.

However, despite the protests, the implementation of VAT was seen as being necessary by the South African government in order to replace the failing General Sales Tax in place at the time, as international experience had shown that General

<sup>40</sup> Rita M. Bynes, ed. *South Africa: A Country Study*. Washington: GPO for the Library of Congress (1996). Available at <http://countrystudies.us/south-africa/63.htm> [Accessed 13/08/2008]

<sup>41</sup> *ibid*

<sup>42</sup> *ibid*, LexisNexis *Value-Added Tax* (1991) 1-3

<sup>43</sup> Christopher S. Wern. *Paralyzing South Africa Strike Ends*. The New York Times (November 6, 1991). Available at <http://query.nytimes.com/gst/fullpage.html?res=9D0CE4D71E30F935A35752C1A967958260#> [Accessed 13/08/2008]

<sup>44</sup> *ibid*

<sup>45</sup> *ibid*

Sales Tax was difficult to control and monitor when the rate exceeded ten per cent. General Sales Tax was a retail sales tax which was otherwise referred to as a single stage retail sales tax. The retail sales tax worked in the exact same manner which it described – all the tax was collected at a single stage. The ‘single stage’ was the final point of distribution to the customer. Thus, businesses were required to obtain a registration certificate in order to acquire goods without being subjected to the retail tax. Thus, it may be said “*the objective behind the proposal was to create a better balanced tax framework, with less emphasis on personal direct taxation*”<sup>46 47</sup>

It may be of interest to note that a few years after the implementation of VAT the South African Minister of Finance appointed a Commission to investigate the VAT system that had been implemented. This Commission was required to pay special attention “*to the advisability and effectiveness of zero rating or exemption of certain foodstuffs and other goods and services and of multiple differential rates of VAT*”<sup>48</sup>. The Commission recommended the following, including further recommendations approximately a year later, with regards to the VAT system and possible alternations to the VAT system implemented in South Africa:

- *“Further erosion of the VAT base through zero-rating or exemptions should not be considered;*
- *a review of the present list of zero-rated basic foodstuffs should be undertaken with a view to the possible redefinition of certain items or substitution of presently zero-rated goods with alternative items; and*
- *a higher VAT rate on luxury goods or a multiple VAT rate system should not be adopted;*
- *the exemption in respect of financial services be narrowed and that the following be brought into the VAT net:*
  - └ *all fee-based financial services and*
  - └ *all fee-based services in respect of life insurance and other superannuation funds*”<sup>49</sup>

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<sup>46</sup> *ibid*, LexisNexis *Value-Added Tax* 1-8

<sup>47</sup> *ibid*. 1-3 – 1-8

<sup>48</sup> *ibid*, 1-9

<sup>49</sup> *ibid*, 1-9

The above recommendations by the Commission may remind one of the OECD's questioning "*the effectiveness of reduced VAT rates to achieve distributional objective[s]*"<sup>50</sup>, that is, the promotion of an economic equity by alleviating tax on poorer households. To an extent, the South African Government did not adopt certain recommendations made by the Commission. While zero-rating of certain food stuff does exist within the South African VAT system, as well as exemption from VAT in certain circumstances, the South African VAT system otherwise follows a single VAT rate, known as the standard VAT rate.

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<sup>50</sup> *ibid*, *OECD Consumption Tax* 39

## CHAPTER TWO<sup>B</sup>

### EXAMPLES OF VALUE-ADDED TAX AND E-COMMERCE TRANSACTIONS

For purposes of this paper, three different examples have been used in order to illustrate implications of VAT in South Africa in terms of E-commerce transactions, specifically in relation to the provision of supplies by foreigners to South Africans by means of E-commerce, and vice versa. As each case may differ in facts, so the outcome and VAT implications may differ. Thus, the use of three examples may provide for a broader understanding of E-commerce and the VAT implications thereof within South Africa.

#### *Case Study One – South African Resident Providing Services to Non-Resident*

A South African computer programme consultant (herein after referred to as Alpha) performs consulting work for several companies, one of which is a United Kingdom (hereinafter referred to as UK) company. The UK Company develops software for business users. Once the software has been developed, Alpha logs into the UK Company's network and performs tests on the "developed software". All work performed and saved by Alpha occurs on the UK company's network. In fact, Alpha is unable to save any of the developed software, or tests relating to the developed software, on his local network. Alpha is paid a "consulting fee" by the UK Company for the test work performed. Note should be made of the fact that Alpha never actually leaves South Africa and all work performed is performed via the Internet.

#### *Case Study Two – Non-Resident Search Engine Subscribed to by South Africans*

An overseas UK based company (herein after referred to as Beta) provides custom tailored search engines tailored to the specific customer's business and the information required by the customer enabling the customer to keep up to date and in the know-how of the customer's specific field of business. The custom tailored search engine is developed overseas by Beta and subscribed to by South African residents and is used within South Africa. Beta performs all maintenance and further

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<sup>B</sup> Examples used within this chapter are based on actual business transactions.

development of the search engine. Beta employs agents within South Africa who are paid by way of commission. Beta pays commission to the South African agents for marketing the search engine. The South African customers who subscribe to the search engine subscribe directly to Beta and not through the agent.

**Case Study Three – Resident Provides Goods and then Services to Non-Resident**

A South African software developer (herein after referred to as Gamma) sells software to local and foreign customers. For the purposes of this paper, only the foreign customers and the VAT implications thereof will be examined. Gamma provides the software to the foreign customers in one of two ways:

- i. The software is downloaded by the foreign customer via the internet; or
- ii. The foreign customer orders the software on a disc that is posted to the customer.

After the customer has acquired and installed the software, the customer then has to subscribe to Gamma in order to activate and utilize the software. This means that the customer has to actually connect to Gamma's network. Furthermore, Gamma offers training to its customers in order for the customer to become familiar with the software and how to operate it. The training comprises the receiving of the training, an operational manual and an actual training programme. The foreign customer takes advantage of this offer and sends its employees to South Africa for the training programme.

### CHAPTER THREE

In order to determine the VAT implications in relation to E-Commerce and transactions occurring between non-South Africans and South African residents, the VAT legislation within South Africa and in an international context must first be examined. This chapter will examine the relevant sections of the South African Value-Added Tax Act, No. 89 of 1991 (hereinafter referred to as the VAT Act) in order to determine the VAT implications of the three E-Commerce examples set out in Chapter Two.

It should be noted that the Double Tax Agreements (hereinafter referred to as DTAs) do not extend to VAT. In other words, if a South African is subject to VAT both in, say, the UK and in South Africa on the same item and amount, no VAT relief may be sort in either country by the taxpayer in terms of the DTA. One should be mindful, as a result of the potential double taxation that may exist for VAT, of the “shared basic principles”, as discussed earlier, which are encouraged by the OECD with the purpose of attempting to eliminate double taxation from arising.<sup>51</sup>

In order to determine an individual or company’s VAT liability in South Africa, the definition of “enterprise”, as defined in section 1 of the VAT Act, must be examined. Meeting the definition of “enterprise” is similar to a ‘first VAT liability test’. In other words, in order to be liable for VAT and, therefore, to determine whether there are any specific provisions for or exclusions from VAT, the definition of “enterprise” must first be met, which reads as follows:

**1. Definitions.** – *In this Act, unless the context otherwise indicates –*

**“Enterprise” means –**

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

*Provided that –*

- (iii) (aa) *the rendering of services by an employee to his employer in the course of his employment or the rendering of services by the holder of any office in performing the duties of his office, shall not be deemed to be the carrying on*

<sup>51</sup> Ibid, *OECD Consumption Tax* 24

*of an enterprise to the extent that any amount constituting remuneration as contemplated in the definition of “remuneration” in paragraph 1 of the Fourth Schedule to the Income Tax Act is paid or is payable to such employee or office holder, as the case may be....*

[Underlining and highlighting is extraneous to quotation]

On analysing the definition of “enterprise”, as defined above, we are able to break the definition down into three important criteria, namely:

- i. “An activity”;
- ii. “Continuously or regularly”; and
- iii. “In the course or furtherance of which goods or services are supplied for a consideration”.

The fact the term “activity” is used within the definition of “enterprise” allows for the broadening of the meaning of an “enterprise” beyond mere business profit-making activities.<sup>52</sup> The phrase “continuously or regularly” means any activity that is on-going. Thus it is important to note that, accordingly, as a general rule for purposes of VAT, isolated or once-off transactions will not qualify as the conducting of an enterprise. Lastly, the phrase “*in the course or furtherance...*” implies that provided that any goods or services are supplied in the course or furtherance of receiving a “consideration”, such activity will meet the definition of “enterprise”. In terms of a New Zealand VAT court case<sup>53</sup>, the following was stated with regards to the phrase “*in the course or furtherance of*”:<sup>54</sup>

*“An act done for the purpose or object of furthering the [enterprise], or achieving its goal, can be to help, achieve, or advance, and thus “furtherance” of [an enterprise], although it may not necessarily be always in the course of that [enterprise].”<sup>55</sup>*

In other words, a “supply” made in the “furtherance” of an enterprise may be one that benefits the enterprise and may not necessarily be a “supply” made in the

<sup>52</sup> MC Botes et al *Juta’s Value Added Tax* South Africa (2000) 1 enterprise-5

<sup>53</sup> New Zealand Case N43 (1991) 13 NZTC 3, 361 at 3,366

<sup>54</sup> *ibid*, *Juta’s Value Added Tax* 7-5

<sup>55</sup> *ibid*, New Zealand Case N43. *ibid*, *Juta’s Value Added Tax* 7-5

ordinary “course” of the enterprise.<sup>56</sup> Furthermore, it is not a requirement that a profit must be made from the act of supplying the goods or services.

A person or company does not need to be a resident of South Africa in order to meet the definition of “enterprise”. The definitions of “resident” and “vendor” should be examined in order to understand the meaning of the terms ‘resident’, ‘non-resident’ and ‘vendor’ as these terms are used extensively within section 11 of the VAT Act which will be examined later. “Resident of the Republic” and “vendor” are defined in terms of section 1 of the VAT Act, and reads as follows:

*“vendor” means any person who is or is required to be registered under this Act: Provided that where the Commissioner has under section 23 or 50A determined the date from which a person is a vendor that person shall be deemed to be a vendor from that date;*

*“resident of the Republic” means a resident as defined in section 1 of the Income Tax Act: Provided that any other person to any other company shall be deemed to be a resident of the Republic to the extent that such 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;*

**Section 1 of the Income Tax Act, No. 58 of 1962, “resident” means any –**

- 1) natural person who is –
  - i. ordinarily resident in the Republic; or
  - ii. not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic –
    - (aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and
    - (bb) for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment....
- 2) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic.

[Underlining and highlighting is extraneous to quotation]

The definition of “resident” within the Income Tax Act, No. 58 of 1952 (hereinafter referred to as the Income Tax Act) has been incorporated into the VAT Act. Thus, anyone who meets the definition of “resident” within the Income Tax Act will also be a “resident”, as defined, for VAT purposes. It is important to note that the VAT Act further provides that if any *“person or company carries on in the Republic any enterprise or other activity and has a fixed or permanent*

<sup>56</sup> ibid 7-5

place...relating to such enterprise or other activity”, such a person or company will be deemed a “resident” of South Africa for VAT purposes. As previously mentioned, the term “resident” is used for the zero rating of services in terms of section 11 of the VAT which will be examined later.

The importance of examining the definition of “vendor” is that a “vendor” is “any person who is ...required to be registered” for VAT. In order to determine if a person is required to be registered for VAT, one is referred to section 23 of the VAT Act, which reads as follows:

**23. Registration of persons making supplies in the course of enterprises.** – (1) *Every person who...carries on any enterprise and is not registered, becomes liable to be registered –*

(a) *at the end of any month where the total value of taxable supplies made by that person in the period of 12 months ending at the end of that month in the course of carrying on all enterprises has exceeded R300,000 [Note: this threshold will be changing to R1 million as of 1 March 2009]; ....*

The significance herein is that a person is required to register when he<sup>57</sup> carries on an enterprise and has met the threshold or has reasonable expectation of exceeding the threshold within twelve months. Referring back to the definition of “enterprise”, no mention is made as to whether a person who carries on any enterprise or activity must be a “resident” of South Africa. Thus, it is possible to be a non-resident and liable to register for VAT in South Africa.

Once it has been determined whether an individual or company is liable for VAT in South Africa, then the timing of imposing VAT in terms of the legislation is examined. Section 7 of the VAT Act sets out the conditions for the imposition of VAT, which reads as follows:

**7. Imposition of value-added tax.** – (1) *Subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax –*

(a) *on the supply by a vendor of goods or services supplies by him on or after the commencement date in the course or furtherance of any enterprise carried on by him;*

(b) *on the importation of any goods into the Republic by any person on or after the commencement date; and*

<sup>57</sup> (For the purpose of simplification the pronoun “he” will be used throughout this paper.)

(c) on the supply of any imported services by any person on or after the commencement date,  
calculated at the rate of 14 per cent on the value of the supply concerned or the importation, as the case may be.

[Underlining and highlighting is extraneous to quotation]

In order to impose VAT on an amount in terms of section 7 of the VAT Act, there must be a “supply” which is a “taxable supply” (as defined in terms of the VAT Act and examined further below).

It is important to note that South Africa lacks a ‘place of supply rule’. In other words, South African legislation does not specify where the supply must occur in order to fall within the ambit of the South African VAT legislation. For example, the New Zealand VAT legislation specifically states “in New Zealand” as follows:

*New Zealand  
Goods and Services Tax Act 1985 141*

**8. Imposition of goods and services tax on supply---***(1) ... a tax, to be known as goods and services tax, shall be charged ...on the supply (but not including an exempt supply) in New Zealand of goods and services, ... by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.*

*(2) For the purposes of this Act, goods and services shall be deemed to be supplied in New Zealand if the supplier is resident in New Zealand, and shall be deemed to be supplied outside New Zealand if the supplier is not resident in New Zealand:*

*Provided that---*

*(a) Goods and services shall be deemed to be supplied in New Zealand if the supplier is not resident in New Zealand and either---*

*(i) The goods are in New Zealand at the time of supply; or*

*(ii) The services are physically performed in New Zealand by any person who is in New Zealand at the time the services are performed:*

*(b) Where goods and services that are deemed to be supplied in New Zealand pursuant to paragraph (a) of this proviso are supplied to a registered person for the purposes of carrying on that person's taxable activity, those goods and services shall be deemed to be supplied outside New Zealand unless the supplier and the recipient agree that this paragraph shall not apply to that supply.*

[Underlining and highlighting is extraneous to quotation]

As is evident from South Africa’s section 7, Imposition of VAT, of the VAT Act, South Africa does not include a “place of supply rule”. The purpose of a “place of supply rule” provides clarity when and on what transactions a country should impose VAT. This is of particular importance in relation to cross-border

transactions. Theoretically, should a South African resident be carrying on an “enterprise” as defined in terms of the VAT Act, examined above, and enters into a sales transaction outside of South Africa, which is produced, supplied and consumed totally outside of South Africa, which would not normally be subject to VAT within South Africa in terms of the consumption principle, the South African would be liable to account for any VAT arising from such a transaction. A full depth analogy and examination of the “place of supply” rule is a paper in itself. However, it is important to understand issues and problems that may arise when attempting to determine VAT liability in South Africa in relation to cross-border transactions as a result of South Africa’s lack of provision for a “place of supply” rule.

The above extract refers to “goods”, “services”, “supply”, “taxable supply” and “imported services”, all of which are defined under section 1 of the VAT Act, and reads as follows:

***1. Definitions.*** - *In this Act, unless the context otherwise indicates –*  
*“goods” means corporeal movable things, fixed property and any real right in any such thing or fixed property, but excluding - .....*  
*“services” means anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, .....*  
*“supply” includes performance in terms of a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected, and any derivative of “supply” shall be construed accordingly*  
*“taxable supply” means any supply of goods or services which is chargeable with tax under the provisions of section 7(1)(a), including tax chargeable at the rate of zero per cent under section 11;*  
*“imported services” means a supply of services that is made by a supplier who is resident or carries on business outside the Republic to a recipient who is a resident of the Republic to the extent that such services are utilized or consumed in the Republic otherwise than for the purpose of making taxable supplies;*  
[Underlining and highlighting is extraneous to quotation]

Initially the definition of “supply” will be examined. The definition of “supply”, while a list of inclusions has been provided in terms of the legislation in

providing a definition for the word, remains unclear.<sup>58</sup> Turning to foreign case law for authority on the definition, *Calrton Lodge Club v C & E Commrs*<sup>59</sup> held “*that ‘supply’ in the ordinary course of the word [means] to furnish or to serve and was not specifically limited to a supply by way of sale*”<sup>60</sup>. The VAT Act goes further to distinguish between a “supply” and a “taxable supply”. While a “supply” may be “*to furnish or to serve*”<sup>61</sup>, a “taxable supply” is viewed as a “supply” which is made “*in the course or furtherance*” of an enterprise and is, therefore, subject to VAT.<sup>62</sup>

“Goods” are things which been defined as anything “corporeal” in accordance with their commonly accepted dictionary definition as anything that is “tangible”. The definition of “corporeal” has been defined as the following:<sup>63</sup>

*“An object is considered to be corporeal if it occupies space and can be perceived by any of the five senses. Natural forces and energies such as gravity, heat, light, sound, radioactivity and electricity are usually considered incorporeals because they do not occupy space.”*<sup>64</sup>

Thus, we may surmise from this interpretation and definition of “corporeal”, that all incorporeal items will fall under the definition of “services”. The downloading of software may be viewed as an “incorporeal” item as it may be viewed as the sharing of information, “know-how” and intellectual property. If downloading is in fact “intellectual property”, then the downloading of software will in fact meet the definition and requirements for the “supply of services”. It should, furthermore, be noted that the OECD has also stated that “*for purposes of consumption taxes, the supply of digitised products should not be treated as a supply of goods*”<sup>65</sup>. It is of vital importance to determine whether the downloading of software meets the definition of “goods” or “services”, as the importation of “goods” is subject to VAT in all circumstances; whereas the importation of “services” is only

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<sup>58</sup> *ibid*, *LexisNexis Value Added Tax* 5-3

<sup>59</sup> [1974] STC 507

<sup>60</sup> *ibid*, *LexisNexis Value Added Tax* 5-3

<sup>61</sup> *ibid*

<sup>62</sup> *ibid*, *Juta’s Value Added Tax* 1 taxable supply - 1

<sup>63</sup> *ibid*, *Juta’s Value Added Tax* 1 goods-1

<sup>64</sup> CG van der Merwe in Jourbert (ed) *The Law of South Africa* vol 27 ‘Things’ para 16. *ibid* *Juta’s Value Added Tax* 1 goods-1

<sup>65</sup> *ibid*, *OECD Consumption Tax* 97

subject to VAT “to the extent that the services will be used for non-taxable purposes”<sup>66, 67</sup>.

Leading on from the definition of “goods” we need next to examine the definition of “services”. The broad definition of “services” allows for nearly all supplies that do not meet the definition of “goods” to fall within the ambit of the definition of “services”.<sup>68</sup> It is interesting to note that “imported services” have been further defined within the South African VAT legislation. The definition of “imported services” includes a proviso that the supply will meet the definition of “services” only where the services are supplied for purposes other than making “taxable supplies”. In other words, should the services be imported for consumption within SA and for utilisation within the recipient’s business for purposes of making “taxable supplies”, then such importation will not fall within the ambit of the definition of “imported services”. In short, only where South African recipients use the “imported services” for purposes of private use, will such importation fall within the ambit of the definition of “imported services” and, therefore, fall within the ambit of the VAT Act.<sup>69</sup> Where the “imported services” are used for making “taxable supplies”, they are excluded from VAT. Thus, where the importer of the “services” is the end-user with no further benefaction, then the service is subject to VAT. But where the importer uses the service to further produce, fabricate or render a taxable good or service (“taxable supplies”) it is not subject to VAT.

It may be of interest to note that in terms of section 11(2)(m) of the VAT Act (examined later) the sharing of information and know-how would be the supply of ‘intellectual property’ which would fall within the ambit of “services” listed within section 11(2)(m). Thus, such supply of services would be zero-rated for purposes of VAT, however, section 11(2)(m) may only be applied “*where and to the extent those rights are for use outside the Republic*”<sup>70</sup>.

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<sup>66</sup> *ibid*, *Juta’s Value Added Tax 1* good-1

<sup>67</sup> *ibid*

<sup>68</sup> *ibid*, *Juta’s Value Added Tax 1* services-1

<sup>69</sup> *ibid*, *Juta’s Value Added Tax 1* imported services-1

<sup>70</sup> Section 11(2)(m) of the VAT Act, No. 89 of 1991

## “EXPORTATION” AND “IMPORTATION”

As this paper will be focusing primarily on the importation and exportation of goods and services through E-commerce transaction, it is necessary to examine the definition of “imported” and “exported”. The VAT Act specifically deals with “importation” in respect of “services” and “goods” in section 13 and 14 of the Vat Act, which will be dealt with and examined presently. “Exportation” on the other hand is dealt with within subsections of the VAT Act. In order to obtain an understanding of the different VAT implications with regards to “importation” and “exportation” it may be easier to deal with the two different aspects separately.

### “Importation of Goods”

VAT implications for the importation of “goods” into South Africa are set out in section 13 of the VAT Act. Relevant subsection of section 13 of the VAT Act reads as follows:

**13. Collection of tax on importation of goods, determination of value thereof and exemptions from tax. – (1) For the purposes of this Act goods shall be deemed to be imported into the Republic on the date on which the goods are in terms of the provisions of the Customs and Excise Act deemed to be imported:**  
*Provided that –*

- (i) goods which are entered for home consumption in terms of the Customs and Excise Act, shall be deemed to have been imported on the date on which they are so entered; ....*
- (2) For the purposes of this Act the value to be placed on the importation of goods into the Republic shall be deemed to be –*
  - (a) where such goods are entered or are required to be entered for home consumption in terms of the Customs and Excise Act, the value thereof for customs duty purposes, plus any duty levied in terms of the said Act in respect of the importation of such goods, plus 10 per cent of the said value; or...*
- (5) The Commissioner may make such arrangements as the Commissioner may deem necessary –*
  - (a) for the collection (in such manner as the Commissioner may determine) by –*
    - (i) any officer performing his or her duties under the control, direction or supervision of the Commissioner; or*
    - (ii) Managing Director of the South African Post Office Limited on behalf of the Commissioner,*

*Of the tax payable in terms of this Act in respect of the importation of any goods into the Republic; and...*

[Underlining and highlighting is extraneous to quotation]

A fundamental principle of VAT is that it is based on “consumption”. In other words, the principle behind VAT is that “*VAT is a consumption tax and its goal is to tax services and intangibles in the jurisdiction where they are actually consumed*”<sup>71</sup>. Thus, a common phrase found within section 13 of the South African VAT Act is “*goods... entered for home consumption...*”. To determine whether the goods imported into South Africa are liable for VAT, it must be determined whether the goods have entered into South Africa for the purpose of being “consumed” within South Africa. It should be noted that generally the supplier collects the VAT on the sale of goods, which is then paid over to SARS. However, circumstances arise where the supplier is a non-resident and is not a registered South African VAT vendor. Thus, in such cases, when “goods” are imported into South Africa directly from the foreign supplier to the South African recipient, the VAT Act has granted authority to, for example, the Post Office, to collect the VAT payable on the imported “goods” directly from the recipient upon collection of the “goods”.

#### **“Importation of Services”**

VAT implications for the importation of “services” into South Africa are set out in section 14 of the VAT Act. The relevant subsection of section 14 of the VAT Act reads as follows:

**14. Collection of value-added tax on imported services, determination of value thereon and exemptions from tax. – (1) Where tax is payable in terms of section 7(1)(c) in respect of the supply of imported services the recipient shall within 30 days of the date referred to in subsection (2) –**

- (a) furnish the Commissioner with a declaration (in such form as the Commissioner may prescribe) containing such information as may be required; and...
- (2) For the purposes of this Act, a supply of imported services shall be deemed to take place at the time an invoice is issued by the supplier or recipient in respect of that supply or the time any payment is made by the recipient in respect of that supply, whichever time is the earlier.
- (3) For the purposes of this Act, the value to be placed on the supply of imported services shall, save as otherwise provided in this section, be the value of the consideration for the supply, as determined in terms of section 10(3) or the open market value of the supply, whichever is the greater....
- (5) The tax chargeable in terms of section 7(1)(c) shall not be payable in respect of –
  - (d) a supply by a person of services as contemplated in terms of proviso (iii)(aa) to the definition of “enterprise” in section 1.

<sup>71</sup> *ibid*, OECD Consumption Tax 19

Following the same principle as laid out above, that is, the consumption principle, “imported services” are liable for VAT where the “service” enters South Africa for purposes of being consumed within South Africa. However, the “importation of services” differs slightly from the “importation of goods” with regards to VAT implications thereof. “Imported Services” are specifically defined in section 1 of the VAT Act (refer above). To reiterate, where “services” are imported into South Africa for the purpose of being consumed by making “taxable supplies” within South Africa, such “importation” is not subject to VAT. Section 14 of the VAT Act further sets out the requirements for paying over any VAT owing to SARS on the importation of services into South Africa. Another significant difference between section 13 and section 14 of the VAT Act is that section 14 of the VAT Act places the responsibility of paying over any VAT owing to SARS in the hands of the recipient. Thus, for example, if an individual downloads a movie from the Internet, deemed to be supply of a service, the recipient is responsible for paying the VAT portion on the purchase price over to SARS.

The application of section 14(5)(b) read in conjunction with section 11(2)(k) of the VAT Act for the treatment of a “supply of services” made outside of South Africa, which are “imported” into South Africa, to be consumed within South Africa by a non-resident non-vendor for purposes other than to make taxable supplies, may be an interesting analogy at this point. Within a recent VAT case, the Metropolitan Life Limited v Commissioner for SARS<sup>72</sup> (hereinafter referred to as the Metropolitan case), a non-resident non-vendor who was the recipient of “imported services” which were consumed within South Africa for purposes other than to make taxable supplies, attempted to apply section 14(5)(b) read in conjunction with section 11(2)(k) of the VAT Act in order to zero rate “imported services” into South Africa. Section 14(5)(b) of the VAT Act states that “ *the tax chargeable in terms of section 7(1)(c) shall not be payable in respect of...a supply which, if made in the Republic, would be charged with tax at the rate of zero per cent applicable in terms of section 11 or would be exempt from tax in terms of section 12*”. Section 11(2)(k) of the VAT Act states that where “*the services are physically rendered elsewhere than in the Republic...*” such supply of services will be zero rated for VAT purposes. In other words, while the supply of services were to a non-resident and entered into outside of

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<sup>72</sup> Case No.: A 232/2007

South Africa, the question arises that if the supply was made within South Africa, and was entered into by a South African resident, what tax consequences would have arisen for the South African resident for such a supply? Argument could be made that if this is in fact how the legislation reads and, furthermore, if this is the intention of the legislation, then should such a service have been entered into within South Africa and “physically rendered outside of South Africa” then such “imported services” should be zero rated.

The judge ruled in favour of the Commissioner in the Metropolitan case, but it should be noted that this was a High Court case and, therefore, could possibly still be appealed to the Supreme Court. Analysing and examining whether an appeal would be successful would constitute a paper on its own and falls outside the ambit of this paper and, therefore, will not be discussed in depth.

However, it may be well to recognise that circumstances may arise where a recipient, who is not a resident of South Africa, consumes “imported services” within South Africa, for purposes other than for making taxable supplies, where such “services” were in fact rendered elsewhere than in the Republic. A perfect example may be the subscription and use of a search engine. For example, a tourist visits an Internet Café in South Africa and logs into the search engine to which he subscribes. The tourist entered into his search engine subscription in France. As the tourist is presently utilising the search engine within South Africa (presuming for now that this constitutes a “supply of services”), the tourist is in fact “importing services” into South Africa which are, furthermore, being consumed for purposes other than for making taxable supplies. Theoretically, the tourist has just become liable for VAT within South Africa. However, this search engine is completely maintained overseas, and all the information contained on the search engine is uploaded overseas. One may here assume that, for all intents and purposes, the services, relating to the provision of the search engine and fulfilling the tourist’s subscription, “*are physically rendered elsewhere than in the Republic*”<sup>73</sup>. Thus, should one examine this example within the context of a South African resident who entered into the search engine subscription within South Africa, but all other facts remained the same, the South African resident would probably be able to apply section 11(2)(k) of

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<sup>73</sup> Section 11(2)(k) of the VAT Act.

the VAT Act, in which case, the “imported services” would be zero rated for purposes of determining VAT.

### “Exportation” of Goods and Services

VAT implications for the exportation of “goods” and “services” from South Africa to an export country may be found within section 11 of the VAT Act. Section 11 of the VAT Act deals with zero-rating items. VAT is imposed either at the standard rate of 14 per cent or at zero per cent. “Goods” and “services” that may be zero rated for VAT purposes are specifically dealt with in section 11 of the VAT Act. In other words, section 11 of the VAT Act sets out the exceptions to levying VAT at the current standard rate of 14 per cent.<sup>74</sup> Zero-rating of exports is “aimed at promoting exports and enhancing their competitiveness in the world market”<sup>75</sup>.

### “Exportation of Goods”

The relevant subsection of section 11 of the VAT Act that deals with the exportation of “goods” within the context of this paper reads as follows:

**11. Zero rating – (1)** *Where, but for this section, a supply of goods would be charged with tax at the rate referred to in section 7(1), such supply of goods shall, subject to compliance with subsection (3) of this section, be charged with tax at the rate of zero per cent where –*

- (a) the supplier has supplied the goods (being movable goods) in terms of a sale or instalment credit agreement and –*
  - (i) the supplier has exported the goods in the circumstances contemplated in paragraph (a), (b) or (c) of the definition of “exported” in section 1; or*
  - (ii) the goods have been exported by the recipient and the supplier has elected to supply the goods at zero rate as contemplated in Part 2 of an export incentive scheme referred to in paragraph (d) of the definition of “exported” in section 1;*

*Provided that:....*

[Underlining and highlighting is extraneous to quotation]

It is important to note that while the definition of “goods” as defined in terms of section 1 of the VAT Act includes “fixed property” for purposes of zero-rating and exportation, in terms of section 11 (1) (a) and section 1 of the VAT Act respectively, the VAT Act specifically includes the provision that the zero-rating and

<sup>74</sup> *ibid*, *Juta’s Value Added Tax* 11-9

<sup>75</sup> *ibid*

exportation of “goods” will only apply to “movable goods”. In other words, section 11(1)(a) of the VAT Act (the zero-rating of “exported goods”) will not apply to “fixed property”. Upon determining that an item meets the definition of “goods”, as defined in section 1 of the VAT Act read with the section 11(1)(a) provision, the conditions given below must be met in order to determine whether the definition of “exported” has been met. “Exported” has been specifically defined in section 1 of the VAT Act, and reads as follows:

***1. Definitions.*** – *In this Act, unless the context otherwise indicates –*  
***“exported”, in relation to any movable goods supplied by any vendor under a sale or an instalment credit agreement, means –***

- (a) consigned or delivered by the vendor to the recipient at an address in an export country as evidenced by documentary proof acceptable to the Commissioner; or*
- (b) delivered by the vendor to the owner or charterer of any foreign-going ship contemplated in paragraph (a) of the definition of “foreign-going ship” or to a foreign-going aircraft when such ship or aircraft is going to a destination in an export country and such goods are for use or consumption in such ship or aircraft, as the case may be; or*
- (c) delivered by the vendor to the owner or charterer of any foreign-going ship contemplated in paragraph (b) of the definition of “foreign-going ship” for use in such ship; or*
- (d) removed from the republic of an export incentive scheme approved by the Minister.*

[Underlining and highlighting is extraneous to quotation]

Where the supplier exports the movable goods to the recipient in an export country, such exportation is referred to as “direct exports”. In such an instance, the supplier, being a South African resident and VAT vendor, is responsible for the exportation of the goods to the recipient, and may zero rate the supply.

In contrast, “indirect exports” occur when the recipient exports the movable goods from South Africa to an export country. Provided that satisfactory documentation can be furnished that the movable goods are being exported and furthermore, the supplier has delivered the goods to a South African port (e.g. airport), the supplier may zero-rate the goods. However, it is important to note that the onus of proof is on the supplier to show that the goods were in fact removed from South Africa. The supplier remains liable to SARS for any VAT that may be payable. Should the recipient export the goods and the supplier chooses not to zero-rate such a supply, the recipient will be entitled to claim a VAT refund upon exiting

South Africa with the goods. As “indirect exports” have been labelled the “*risky method of exporting goods*”<sup>76</sup> it is advisable for the supplier, in such circumstances, to levy VAT at the standard rate and allow the recipient to claim a VAT refund upon exiting South Africa.

### “Exportation of Services”

The relevant subsection of section 11 of the VAT Act that deals with the exportation of “services” within the context of this paper reads as follows:

- (2) *Where, but for this section, a supply of services would be charged with tax at the rate referred to in section 7(1), such supply of services, subject to compliance with subsection (3) of this section, be charged with tax at the rate of zero per cent where –*
- (l) *the services are supplied to a person who is not a resident of the Republic, not being services which are supplied directly –*
- (ii) *in connection with movable property (excluding debt securities, equity securities or participatory securities) situated inside the Republic at the time the services are rendered, except movable property which –*
- (aa) *is exported to the said person subsequent to the supply of such services;*  
or
- (bb) *forms part of a supply by the said person to a registered vendor and such services are supplied to the said person for purposes of such supply to the registered vendor; or*
- (iii) *to the said person or any other person, other than in circumstances contemplated in subparagraph (ii) (bb), if the said person or such other person is in the Republic at the time the services are rendered, and not being services which are the acceptance by any person of an obligation to refrain from carrying on any enterprise, to the extent that the carrying on of that enterprise would have occurred within the Republic; or*
- (m) *the services comprise –*
- (i) *the filing, prosecution, granting, maintenance, transfer, assignment, licensing or enforcement, including the incidental supply by the supplier of such services of any other services which are necessary for the supply of such services, of intellectual property rights, including patents, designs, trade marks, copyrights, know-how, confidential information, trade secrets or similar rights; or ...*  
*where and to the extent that those rights are for use outside the Republic; or..*
- (r) *the services comprise the vocational training of employees (other than educational services contemplated in section 12(h)) for an employer who is not a resident of the Republic and who is not a vendor; or ...*
- (v) *the services relate to goods under warranty to the extent that the services are*
- (i) *provided in terms of that warranty;*
- (ii) *supplied to the warrantor for consideration under that warranty given by the*

<sup>76</sup> Costa Divaris & Michael Stein et al *BSP Seminars The VAT Consequences of Business Transactions, Part 2: VAT on Imports & Exports* (2008)

- warrantor who is*
- (aa) *not a resident of the Republic*
  - (bb) *not a vendor; and*
  - (cc) *outside the Republic at the time the services are rendered; and*
  - (iii) *in respect of goods that were subject to tax upon importation (in terms of section 7 (1) (b) of this Act); or*

[Underlining and highlighting is extraneous to quotation]

With regards to the “exportation of goods”, section 11 of the VAT Act also sets out the various “services” that may be zero-rated. As explored above, “services” comprise nearly all supplies that do not meet the “goods” definition. For purposes of this paper, there are four subsections within section 11(2) of the VAT Act that require examination and understanding in order to determine whether the services provided are classified as “exportation of services” and, therefore, zero-rated.

In terms of section 11 (2) (l) of the VAT Act, where a South African resident and vendor provide services to a non-resident, such services are deemed to be the “exportation of services” and may be zero-rated. However, a condition in the application of this subsection being applicable is that the non-resident may not be in South Africa at the time the services are rendered. That being said, there are further subsections that may allow for the zero-rating of services where the non-resident is in South Africa at the time the services are provided. For example, section 11 (2) (r) of the VAT Act sets out that where “vocational training” is provided to the employees of a non-resident employer, such training may be provided at a zero VAT rate. The word “vocational” is not defined within the VAT Act. The Oxford English Dictionary defines “vocational” as that which is “*connected with the skills, knowledge, etc. that you need to have in order to do a particular job*”<sup>77</sup>. The principle behind the introduction and implementation of such a section may be two-fold:

1. *“The international community has, in recent years, started to make use of local training facilities;*

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<sup>77</sup> Oxford English Dictionary *Vocational* Oxford University Press (2005). Available at [http://www.oup.com/oald-bin/web\\_getald7index1a.pl](http://www.oup.com/oald-bin/web_getald7index1a.pl) [Accessed 11/01/2009]

2. *Although the training of employees takes place in [South Africa], the services are only consumed once the employees apply their newly acquired skills at their place of employment outside [South Africa].*<sup>78</sup>

Section 11 (2) (m) of the VAT Act relates specifically to Intellectual Property and when Intellectual Property may be zero rated for VAT purposes. The phrase “other services which are necessary for the supply of such services”, which is contained within section 11 (2) (m) of the VAT Act, is based on section 11 (2) (f) of the New Zealand Goods and Services Tax Act 1985 (the “NZ VAT Act”).

<p style="text-align: center;"><b>New Zealand</b> <i>Goods and Services Tax Act 1985 141</i><sup>79</sup> <i>Commenced: 3 Dec 1985</i> <i>II: Imposition of Tax</i></p> <p><b>11. Zero rating.</b> (2) <i>Where, but for this section, a supply of services would be charged with tax under section 8 of this Act, any such supply shall be charged at the rate of zero percent where---</i></p> <p>(f) <i>The services are---</i></p> <p>(i) <i>The filing, prosecution, granting, maintenance, transfer, assignment, licensing, or enforcement of intellectual property rights, including patents, designs, trade marks, copyrights, know-how, confidential information, trade secrets, or similar rights; or</i></p> <p>(ii) <i>The acceptance of an obligation to refrain from pursuing or exercising in whole or in part any such rights,---</i></p> <p><i>where and to the extent that those rights are for use outside New Zealand; ...</i></p>
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The NZ VAT Act provides a guideline for this phrase and “*specifically provides that such other services include ‘services involved in the making of searches, the giving of advice, opposing the grant or seeking the revocation of such rights, or opposing steps taken to enforce such rights’*”<sup>80</sup>. An important aspect of section 11 (2) (m) of the VAT Act is that the “*rights are for use outside... [South Africa]*”<sup>81</sup> as briefly explored earlier. Thus location of where the “rights” are utilized or consumed is the relevant criterion for determining whether the services supplied in connection with the intellectual property is zero-rated or not. In other words, it is irrelevant if the recipient of the rights is a South African resident or

<sup>78</sup> *ibid*, *Juta's Value Added Tax* 11-31

<sup>79</sup> New Zealand Goods and Services Tax (Value-Added Tax) Act 1985. Available at <http://gpacts.knowledge-basket.co.nz/gpacts/reprint/text/1985/an/141.html> [Accessed 24/08/2008]

<sup>80</sup> *ibid*, *Juta's Value Added Tax* 11-29

<sup>81</sup> Section 11 (2) (m) of the SA Value-Added Tax Act, No. 89 of 1991.

vendor, it is merely necessary for the intellectual property rights to be used outside of South Africa to be a deemed “exportation of services”.<sup>82</sup>

A final section that requires examination and analysing is section 54 of the VAT Act which deals with “agents” and the rules and obligations pertaining to “agents” for the purposes of VAT.

**54. Agents and auctioneers.** – (1) *For the purposes of this Act, where an agent makes a supply of goods or services for and on behalf of any other person who is the principal of that agent, that supply shall be deemed to be made by that principal and not by that agent:*  
...  
(2A) (a) *For the purposes of this Act, where any goods are imported into the Republic by an agent who is acting on behalf of another person who is the principal for the purposes of that importation, that importation shall be deemed to be made by that principal for the purposes of that importation, that entry or other document prescribed in terms of the Customs and Excise Act in relation to that importation may nevertheless be held by such agent.*  
(b) *Notwithstanding the provisions of paragraph (a), where any goods are imported into the Republic by an agent who is acting on behalf of another person who is the principal for the purposes of that importation, and –*  
(i) *the agent is a registered vendor; and*  
(ii) *the principal is not a resident of the Republic and is not a registered vendor; and*  
(iii) *the goods are imported by the principal for the purposes of a supply made or to be made by him to a person in the Republic; and*  
(iv) *the agent obtain and retains documentary proof, as is acceptable to the Commissioner - ...*  
*that importation shall for the purposes of this Act be deemed to be made by such agent and not by that principal.*

An “agent” is “a person whose job is to act for, or manage the affairs of, other people in business...”<sup>83</sup>. Note that section 54 of the VAT Act provides for circumstances where an agent imports “goods” into South Africa on behalf of a non-resident but does not provide for the “importation of services”. One must be mindful of the fact that the recipient is required to account for the VAT on the “importation of services” which are not used for the purpose of making taxable supplies.

Services rendered by agents give rise to commission revenue in the hands of the “agent”. Such ‘commission’ will not be subject to VAT in terms of section

<sup>82</sup> *ibid*, *Juta's Value Added Tax* 11-29

<sup>83</sup> Oxford English Dictionary *Agent* Oxford University Press (2005). Available at [http://www.oup.com/oald-bin/web\\_getald7index1a.pl](http://www.oup.com/oald-bin/web_getald7index1a.pl) [Accessed 11/01/2009]

11(2)(l) of the VAT Act as described above. This has also been upheld by SARS in terms of VAT Ruling 358.<sup>84</sup>

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<sup>84</sup> SARS VAT Ruling 358: “*Question: Will the consideration received by an RSA-agent, for services rendered by the agent on behalf of the overseas principal to local clients, be subject to VAT?*  
*Answer: The services rendered by the RSA-agent on behalf of the overseas principal to local clients will not be subject to VAT, as the services are deemed to be rendered by the overseas principal. The fee or commission charged by the agent will however, be subject to VAT at the zero rate in terms of section 11(2)(l).*  
*However, should the consideration which the agent receives on behalf of the overseas principal, exceed the R300 000 threshold as specified in section 23(1), the overseas principal will be obliged to register as a vendor for VAT purposes in terms of the said section read with the definition of “enterprise” in section 1. The services supplied by the principal to the local clients, will in these circumstances, be subject to VAT at the standard rate in terms of section 7(1)(a). The fee or commission charged by the agent in this circumstance, will be subject to VAT at the standard rate in terms of section 7(1)(a).” Available at <http://www.sars.gov.za/home.asp?pid=4723> [Accessed 11/01/2009]*

## CHAPTER FOUR

While this paper deals with South African domestic tax issues in relation to VAT it is, nevertheless, important to review and examine both the OECD commentary on E-commerce transactions and the New Zealand legislation in conjunction with any commentary or discussion documents relating to the issue of imposing VAT on E-commerce transactions.

The purpose of examining and reviewing OECD Commentary in relation to the topic at hand is that although South Africa is not currently a member of the OECD, South Africa does follow the OECD Commentaries in relation to Double Tax Agreements. Furthermore, as per *Secretary for Inland Revenue v Downing* case<sup>85</sup>, South African courts have also accepted the use of OECD Commentary for interpreting tax treaties. While VAT does not actually fall within the ambit of Double Tax Agreements, the principle remains that South Africa follows OECD frameworks and thus it is important to understand what the OECD's recommendations are in relation to VAT on E-commerce transactions.

The reason for examining and reviewing New Zealand VAT legislation, as stated above, and any commentary and discussion documents relating to the imposition of VAT on E-commerce transactions is due to the fact that South African VAT legislation is based on the New Zealand VAT legislation. To best comprehend the essence of the South African VAT issue one should study the source.

### OECD COMMENTARY ON E-COMMERCE TRANSACTIONS

The OECD have published guidelines in relation to the "place of consumption" definition to assist in determining which country has the right to impose VAT and the manner in which to impose VAT on E-commerce transactions.

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<sup>85</sup> *Secretary for Inland Revenue v Downing* 37 SATC 249 (hereinafter the "Downing case").

A brief summary of the Downing case is as follows:

Downing lived in South Africa, after which he emigrated to, and became a resident of, Switzerland. Due to South African Exchange Control regulations Downing was not allowed to remove all his money and, as a result, left a large portfolio of shares in South Africa. Downing appointed Smith to look after and deal in his shares and to manage his portfolio. The South African Revenues Services (hereinafter "SARS") stated that there was a permanent establishment in South Africa, due to the use of an 'agent' (Smith), and as such taxed the profits arising from the portfolio. However, if Downing could prove that there was no permanent establishment then SARS would not be able to tax him as only his resident country would have such a right in terms of the Double Tax Agreement between South Africa and Switzerland. This case laid down authority for courts to use the OECD Commentary as guidelines.

It is important to note that application of these guidelines is only intended for purposes of international cross-border supplies, and in particular, as a result of E-commerce, to assist in defining “place of consumption” for such supplies *provided* that the suppliers are non-resident and are not registered or required to be registered as VAT vendors in the jurisdiction where consumption occurs.<sup>86</sup>

The OECD E-commerce consumption definition for the imposition of VAT guidelines includes the following “Ottawa Taxation Framework Conditions”<sup>87</sup>:

- “1. In order to prevent double taxation...rules for the consumption taxation of cross-border trade should result in taxation in the jurisdiction where consumption takes place.*
- 2. For the purpose of consumption taxes, the supply of digitised products should not be treated as a supply of goods.*
- 3. Where business acquires services and intangible property from a non-resident vendor, consideration should be given to the use of reverse charge, self-assessment or other equivalent mechanism.”<sup>88</sup>*

The OECD has recommended three different approaches in relation to effective tax collection for cross-border transactions. These recommendations include the “registration system”, the “reverse charge system” and the collection of VAT by customs. The latter is the most common in relation to the importation of “goods” where ‘national borders’ may be identified and such collection can be effectively enforced. For obvious reasons, the collection of taxes by means of customs control in relation to the “importation of services” arising from E-commerce cross-border transactions is both impractical and physically impossible. In terms of the “reverse charge mechanism”, the recipient of the “supply” is liable to account for the VAT arising on the supply. In terms of the “registration system”, the supplier is required to register for VAT within the country he is making supplies (provided he meets the requirements to register).<sup>89</sup>

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<sup>86</sup> Ibid, *OECD Consumption Tax* 98

<sup>87</sup> *ibid*, 95: “The development of e-commerce in the late 1990s led governments to adopt several principles in the field of consumption taxes. The Ottawa Framework Conditions were endorsed by Ministers in October 1998”

<sup>88</sup> *ibid* 97

<sup>89</sup> *ibid* 98

Furthermore, based on the “Ottawa Taxation Framework Conditions” guidelines above, the OECD advocates the “consumption principle” rather than the “origin principle”. The “consumption principle” is based on VAT being levied on the end consumer within the jurisdiction where the service or goods are consumed. The “origin principle” is based on VAT being levied on services and goods at their “origin”. In other words, the suppliers are liable for the VAT within the jurisdiction where the goods and services originate from and not where they are consumed.

**NEW ZEALAND DISCUSSION DOCUMENT ON E-COMMERCE AND THE IMPOSITION OF GST<sup>90</sup> ON “IMPORTED SERVICES”<sup>91</sup> IN COMPARISON TO SOUTH AFRICAN LEGISLATION**

The New Zealand Inland Revenue Department issued a discussion document (hereinafter referred to as the Discussion Document) in November 2000 relating to the issue of imposing GST on imported services and, especially, in relation to imported services arising as a result of E-commerce cross border transactions. This Discussion Document set out proposals as how best to impose, enforce and collect GST on “imported services”. The Discussion Document arrives at a recommended proposal after examining the different VAT methods practised, proposed and recommended by the OECD in their developed “Ottawa Taxation Framework Conditions”<sup>92</sup>. The Discussion Document identifies four key issues relevant to the importation of VAT on imported services:

1. *Determining the appropriate jurisdiction in which a supply occurs and, when necessary, such as in the telecommunications sector, clarifying the rules that determine the place of supply;*
2. *Distinguishing between supplies of goods and services, particularly with respect to digitised products;*
3. *The appropriate mechanism for taxing imported services; and*

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<sup>90</sup> “GST” is the abbreviation for Goods and Services Tax. Please refer to “What Exactly is VAT, Chapter One” of this paper. The terms “GST” and “VAT” may be used interchangeably.

<sup>91</sup> Chapter Five and the examination of the New Zealand discussions on the imposition of VAT in an E-commerce environment is based on the discussion document issued by the New Zealand tax authority. Inland Revenue Department *GST & Imported Services: A Challenge in an Electronic Commerce Environment, A Government Discussion Document* (hereinafter referred to as “NZ GST & Imported Services”) (2001). Available at [http://www.taxpolicy.ird.govt.nz/publications/files/gstis\\_dd.pdf](http://www.taxpolicy.ird.govt.nz/publications/files/gstis_dd.pdf) [Accessed 7/01/2009]

<sup>92</sup> *ibid*, OECD *Consumption Tax* 95

4. *The extent to which efficiency is achieved without significant compliance and administrative costs.*<sup>93</sup>

The Discussion Document examines various options and proposals for the imposition of VAT on imported services and found the best option, being the most practical, cost efficient and enforceable, to be the “reverse charge mechanism” (examined earlier). However, the Discussion Document restricts the implementation of the “reverse charge mechanism” to ‘business-to-business’ transactions. Thus, it should be noted that New Zealand differs from South African VAT legislation in this regard in that within New Zealand *“the application of the reverse charge will be limited to services to the extent that they are acquired by registered persons (or persons liable to be registered) for purposes other than of making taxable supplies”*<sup>94</sup>. Requiring consumers to account for VAT on “imported services” is eliminated through the use of the words *“registered persons (or...liable to be registered)...”*<sup>95</sup>. The reason for this proposal is that New Zealand acknowledges the problem of enforcement and, therefore, the impracticality of imposing such a reverse-charge mechanism on consumers.

In contrast, South Africa has defined “imported services”, which requires self-assessment for VAT purposes, as *“a supply of services...to a recipient who is a resident of the Republic...”*<sup>96</sup>. Thus, theoretically, when a consumer downloads, for example, a music album for US\$8, the consumer is obligated to account for the VAT on the purchase and downloading of this music album, as the consumer has received *“a supply of services...[which have been supplied to the consumer as] a recipient who is a resident of the Republic...”*<sup>97</sup>. The administrative costs in enforcing such obligation on the consumer masses, that is, to account for VAT on such purchases, is both unrealistic and impractical, not to mention the absence of a mechanism to enforce such accounting. Furthermore, it would be interesting to observe how SARS would deal with a consumer walking into a SARS office and attempting to pay VAT on a US\$8 music album purchase!

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<sup>93</sup> *ibid*, NZ GST & Imported Services 3

<sup>94</sup> *ibid* 25

<sup>95</sup> *ibid*

<sup>96</sup> The definition of “imported services” as defined within Section 1 of the VAT Act, No. 89 of 1991

<sup>97</sup> *ibid*

The Discussion Document has proposed the use of the “registration system” to possibly overcome the potential future loss of tax revenue arising from ‘business-to-consumer’ cross-border transactions. In other words, as it is recognised that it is unrealistic to enforce the “reverse-charge mechanism” on the consumer, an alternative solution may be to require a non-resident business making taxable supplies of services within New Zealand to register for VAT and to account for any and all VAT arising from E-commerce transactions occurring between the non-resident company and the New Zealand consumer.<sup>98</sup>

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<sup>98</sup> *ibid*, *NZ GST & Imported Services* 52

## CHAPTER FIVE

### APPLICATION OF THE VAT LEGISLATION

In order to provide a comprehensible application of the South Africa VAT legislation to the case study examples, as set out in Chapter Two, each case study example shall be dealt with separately within this Chapter.

#### Alpha – South African Resident Providing Services to Non-Resident

From the information provided it might be understood that Alpha is an independent contractor and not an employee of the UK Company. Accordingly, the UK Company will not be carrying on a business continuously or regularly in South Africa and will, therefore, not qualify as an “enterprise” within South Africa as defined in the VAT Act. This is based on the fact there is no continuous or regular activity conducted in South Africa. Furthermore, all the customers of the UK Company place their orders directly with the UK Company and the software is developed in the UK.

Alpha is physically located in South Africa carrying on consulting services for various cliental. In other words, Alpha is carrying on an “enterprise” within South Africa. However, with regards to the consulting services performed for the UK Company, all of Alpha’s services are conducted on the UK network which is located in the UK and for the UK Company, a non-resident non-vendor in SA. Thus, Alpha is “exporting” services from South Africa to UK. In terms of section 11(2)(l) of the VAT Act, the provision of services to a non-resident is zero-rated for VAT purposes. However, it should be borne in mind that the services may only be zero-rated if the services are supplied *directly* to the non-resident UK Company and the UK Company is not in South Africa at the time the services are supplied.

While physically located in South Africa, Alpha is applying its skills in the UK via means of the Internet and supplying a service to a non-resident physically outside of South Africa. Notwithstanding the fact that Alpha is “exporting services” to a non-resident recipient, it may be argued that the action of connecting to the UK company’s network may result in the “importing of services” from the UK Company

to the South African resident (Alpha) by making use of the UK Company's network and server, located in the UK. The "importation of services" is a VATable supply in terms of section 14 of the VAT Act. However, in order for section 14 of the VAT Act to apply, the definition and requirements of "imported services", as defined in section 1 of the VAT Act, must be met. "Imported services" is defined as a "*supply of services... to the extent that such services are utilized or consumed*"<sup>99</sup> in South Africa, otherwise than for the purposes of making taxable supplies. As already determined, Alpha is carrying on an "enterprise" in South Africa, and should access and use of the UK company's network be classified and deemed as an importation of services, such importation would in fact be utilized and consumed for purposes of making taxable supplies.

It should be noted that while the determination of whether a 'server' constitutes a 'permanent establishment' or not is explored extensively within the paper, "*International Taxation and Domestic Taxation: Defining 'Source' within and out of an E-Commerce Environment*"<sup>100</sup>, pertaining to determination of income tax (direct taxes), has not been extensively explored within the context of this paper. From research it appears that, as of yet, the proposed deeming of an Internet Service Provider as constituting a permanent establishment for purposes of determining 'source' of revenue has not been a necessity for imposing VAT. As such, the concept of "server", and whether or not it would constitute an 'enterprise' within a jurisdiction, may in fact be a paper on its own and, therefore, will not be explored in depth. However, in terms of a brief examination, in order for a 'server' to meet the definition of an 'enterprise' within South Africa the server would have to be an "*...activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which...services are supplied to any other person for a consideration...*"<sup>101</sup>. Assume, for argument's sake, that Alpha does in fact carry on an activity "continuously or regularly" in South Africa, would it not in fact be Alpha carrying on the continuous activity and not the server? In other words, in terms of VAT, it does not appear necessary to deem a 'server' to be a permanent establishment within a jurisdiction due to the fact that an 'enterprise' may be created by any person, located anywhere in

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<sup>99</sup> Section 1 "imported services" of the Value-Added Tax Act, No.89 of 1991

<sup>100</sup> Referred to in Chapter One and Footnote 1

<sup>101</sup> Definition of "enterprise" in terms of section 1 of the Value Added Tax Act, No. 89 of 1991

the world, carrying on an activity “continuously or regularly” in South Africa for a consideration and “in the course or furtherance of” the enterprise.

**Beta – Non-Resident Search Engine Subscribed to by South Africans**

The recipient of “imported services” is obliged to pay VAT directly to SARS on the value or cost of the imported services. The subscriptions paid by the South African resident to the Internet Search Engine would be viewed as “imported services” as the services, arising as a result of subscribing to the search engine, are being provided by a non-resident to a resident and, furthermore, will be consumed and utilized within South Africa. But should the subscription to the Internet Search Engine be for purposes of making taxable supplies then the definition of “imported services” will not be met and the recipient will not be liable for payment of VAT.

One may refer here to the earlier examination of the Metropolitan case. While the facts of Beta differ in the sense that the imported services are being provided to South African residents unlike in the Metropolitan case where a non-resident was importing the services, the application of section 11(2)(k) of the VAT Act may nevertheless be queried in relation to Beta and its customers. While the South Africans are utilising the services within South Africa, can it be said that the services are being “physically rendered” within South Africa? In terms of section 11(2)(k) of the VAT Act, where the “*services are physically rendered elsewhere than in the Republic...*”, such services may be zero-rated for purposes of VAT. In other words, while the services may meet the definition and requirements of “imported services” resulting in the South African recipients having to account for the VAT (where the services are utilised for purposes other than making taxable supplies), the services may in fact be zero rated for VAT purposes. In analysing the facts, Beta maintains the search engine abroad, all information is “uploaded” abroad, etcetra, thereby giving rise to the debate that the services relating to this search engine are in fact physically rendered elsewhere than in South Africa. However, the rebuttal to this argument may be that the rendering of services is not the maintenance of the search engine but rather the right to access the search engine. Thus, the services are physically rendered where the search engine is accessed, namely South Africa.

One of the reasons for the uncertainty arising from such a cross-border transaction is due to South Africa's lack of "place of supply" rule, as examined earlier. The location as to where the services are "rendered" may be easier to determine should South African VAT legislation have a "place of supply" rule. For example, in terms of the New Zealand VAT legislation "...services... shall be deemed to be supplied outside of New Zealand if the supplier is not resident in New Zealand: provided that... services shall be deemed to be supplied in New Zealand if the supplier is not resident in New Zealand and...the services are physically performed in New Zealand by any person who is in New Zealand at the time the services are performed..."<sup>102</sup>. If such legislation had been enacted within South Africa, in order for services to be deemed to have been rendered within South Africa, the services would have to be "*physically performed in...[South Africa] by...[Beta] who is in...[South Africa] at the time the services are performed...*"<sup>103</sup>.

Do the agents operating in South Africa on behalf of Beta result in Beta meeting the definition and requirements of an "enterprise"? As the agents, defined in Chapter Three, carry neither authority nor power to conclude contracts on behalf of Beta they do not fall within the category of "employee". In other words, as the agents do not act on behalf of Beta and act solely as sale agents, it cannot be said that Beta is carrying on an activity "*continuously or regularly...in the Republic....and in the course or furtherance of which....services are supplied to any other person for a consideration...*"<sup>104</sup>. In fact the only "enterprise" being conducted in South Africa, in terms of these facts, is carried on by the 'agents' in terms of their 'agency enterprise'. The agents earn a commission from Beta for merely advertising the search engine in South Africa. Thus, the agents are in fact providing services to a non-resident and while they are carrying on an "enterprise" as defined, the commission earned by the agents will be zero-rated for VAT purposes in terms of section 11(2)(1) of the VAT Act and as upheld in terms of the SARS VAT Ruling 358, as the services constitute services supplied by person who is not a resident of South Africa.

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<sup>102</sup> Imposition of goods and services tax on supply in terms of Section 8 of New Zealand Goods and Services Tax Act 1985 141

<sup>103</sup> *ibid*

<sup>104</sup> Definition of "enterprise" as defined in Section 1 of the VAT Act, No. 89 of 1991

### *Gamma – Resident Provides Goods and then Services to Non-Resident*

Software is exported from SOUTH AFRICA on physical discs to a non-resident recipient. Gamma delivers the software directly to the recipient in an export country. Such a supply will meet the definition of exported goods in terms of section 11 (1) (a) and will be zero rated for VAT purposes.

Should the recipient choose to “download” the software onto his computer located in an export country, such “downloading” will be deemed a “supply of services” to a non-resident.

The non-resident is required to subscribe to Gamma in order to activate and utilize the software. The subscription is an exportation of services as the non-resident is utilizing the subscription in an export country, however, this may give rise to the debate of “place of supply” rules as illustrated under Alpha. Assuming that the services are “physically rendered” within South Africa, as this is where the software is activated and authorised to be used, the subscription is a provision of services to a non-resident in terms of section 11(2)(l) of the VAT Act. However, should it be viewed that the services are in fact “physically rendered” elsewhere than in South Africa as the software is actually utilised outside of South Africa, then section 11(2)(k) of the VAT Act may apply (as discussed under Alpha). However, in terms of the facts of this case, it may be easier to argue that the services are not “physically performed” outside of South Africa as the clients are required to connect to Gamma’s network, in South Africa, in order to gain authorisation to utilise the software.

The training of the foreign company’s employees is an identifiable and separate activity which Gamma offers to enable the foreign employees to familiarise themselves with the software, and to enable the foreign employees to utilize the software in their country. In other words, the skills and know-how they obtain from the training will be utilized and consumed in their place of business overseas and not in South Africa. In terms of section 11(2)(r) of the VAT Act such “vocational training” (as described above) will be zero rated for VAT purposes and pertains to the consumption principle. In other words, the employees are receiving their training in South Africa, but will only be “consuming” the benefit of the training outside of

South Africa. Should South Africa have adopted the “origin principle” this would have been a perfect example of where South Africa could have imposed VAT.

The primary focus of this paper is to assess the level of proficiency of South African VAT legislation. The above examples, Alpha, Beta and Gamma, are employed to demonstrate the possible diverse interpretations and applications of the South African VAT Act.

## CONCLUSION

In terms of the current VAT legislation it may be observed that section 11(2)(l) of the VAT Act appears to be one of the more common applications of the VAT Act with regards to zero rating the supply of services which are exported. However, it should be noted that opinions have been preferred intimating that there are problems with the application of section 11 (2) (l) of the VAT Act (i.e., services provided to a non-resident) in terms of supplying services within an E-commerce environment. Such commented problems include:

- “i. The difficulty for the supplier to prove that the consumer is not in South Africa at the time when the digitised products are supplied;*
- i. The place of residence of the recipient of the services (outside South Africa) is not conclusive proof that the services will be consumed outside South Africa;*
- ii. The onus of proof is on the supplier; and*
- iii. Difficulty for suppliers to confirm that a consumer is not a resident of South Africa”.*<sup>105</sup>

However, it may be possible to determine the location of the consumer through the Internet Provider address and credit card address of the consumer purchasing the services, thereby determining the consumption location. While such “commented problems” may not be easily overcome, a major factor that may create increasingly more problems is the South African VAT legislation’s lack of a “place of supply” rule. Considering the fact that South Africa adopted, obviously only

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<sup>105</sup> RD de Swardt & R Oberholzer et al *Digitised Products: How Complaint is South African Value-Added Tax?* Meditari Accountancy Research Vol. 14 No. 1 (2006) 25

predominantly, the New Zealand VAT legislation, the question arises: “*why did South Africa opt to exclude the “place of supply” rule?*” The examination and analysis of such a query may be a paper on its own, but the fact remains that the inclusion of a “place of supply” rule is an important and necessary amendment. Such an amendment would surely mitigate the problems arising from not having a “place of supply” rule. The reasoning behind this statement is that while the definition of “enterprise” and the VAT sections pertaining to importation and exportation work in conjunction in order to determine whether a supply is subject to VAT in South Africa, the simple inclusion of a “place of supply” rule would allow for easier determination of VAT liability within South Africa.

Despite the real possibility of double VAT imposition occurring in relation to E-commerce cross border transactions due to VAT not falling within the ambit of DTAs, the OECD has encouraged countries utilising VAT to share “basic principles” in relation to VAT and VAT definitions. The simple sharing of “basic principles” may eliminate VAT double taxation to a large extent. For example, if the destination / consumption principle is adopted and implemented by all countries utilising the VAT system then the importation of goods and services would be VATable in the country of importation and the exportation of goods and services would be zero rated in the country of export. However, to reiterate, where these “basic principles” do not exist, double VAT imposition may arise, for example, one country having a “place of supply” rule and the other lacking such a rule.

As previously mentioned the primary focus of this paper is to assess the implementation of current legislation and to determine VAT implications in relation to current E-commerce cross border transactions. The application of the current South African VAT legislation, in determining VAT implications, may be possible in most E-Commerce cases by means of applying the exportation and importation provisions in conjunction with one of the OECD proposed VAT mechanisms for cross-border transactions. The preferred method, which is also New Zealand’s preferred recommended method and the method followed by South Africa, is the Reverse-Charge mechanism where the recipient of “imported services” is required to account for the VAT. The three examples, Alpha, Beta and Gamma presented above, illustrates the level of efficiency of South African VAT legislation in determining the

VAT consequences of transactions occurring in an E-commerce environment and across borders. There is potential for South African VAT legislation to be improved, updated and altered with regards to imposing VAT on E-commerce cross-border transactions. Aristotle (384BC – 322BC), stated, “*even when laws have been written down, they ought not always to remain unaltered*”<sup>106</sup>. However, until such time that South African legislation is amended to better accommodate E-commerce transactions, for example, with the addition of the “place of supply” rule, our legislation as it stands should be applied and “religiously observed”. In the words of Abraham Lincoln (1809-1865):

*“Let me not be understood as saying that there are no bad laws, nor that grievances may not arise for the redress of which no legal provisions have been made. I mean to say no such thing. But I do mean to say that although that bad laws, if they exist, should be repealed as soon as possible, still, while they continue in force, for the sake of example they should be religiously observed.”*<sup>107</sup>

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<sup>106</sup> Aristotle (384BC – 322BC). Available at <http://www.quotationspage.com/subjects/laws/> [Accessed 12/01/2009]

<sup>107</sup> Abraham Lincoln (1809 – 1865). Available at <http://www.quotationspage.com/subjects/laws/> [Accessed 12/01/2009]

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