A CRITICAL ANAYSIS OF SOUTH AFRICA'S DOMESTIC NEXUS REQUIREMENTS FOR THE TAXATION OF CROSS-BORDER SERVICES.

By:

Kate Dunjane

Student Number: DNJBAB001

SUBMITTED TO THE UNIVERSITY OF CAPE TOWN

in partial fulfilment of the degree MCom: International Taxation

Faculty of Commerce

UNIVERSITY OF CAPE TOWN

Supervisor: Professor Jennifer Roeleveld, Department of Finance and Tax

University of Cape Town

PLAGIARISM DECLARATION

I, Kate Dunjane, know the meaning of plagiarism and declare that all the work submitted in this dissertation, save for the acknowledged, the accordingly cited and the referenced, is my own.

I hereby grant the University of Cape Town free licence to reproduce for the purpose of research either the whole or any portion of the contents in any manner.

Signed by candidate

Kate Dunjane
February 2019

ACKNOWLEDGEMENTS

This journey has been one of the most challenging projects that I have embarked on in my adult life. I have personally grown in many ways and I have overcome things that I never thought I would have the capacity to endure. I am immensely proud of myself for getting this far. I was often doubtful of myself about getting to this stage. And yet, here I am. Standing proud to have produced this work and calling it my labour of love.

My gratitude firstly goes out to my supervisor, Professor Jennifer Roeleveld, for her professional guidance, her patience, her quiet confidence in me and for subtly giving me the space to develop my research at my own pace.

I will forever be indebted to my late grandmother, for her love, her warmth and most importantly her prayers. Thank you Gogo for everything you have done and sacrificed for me. Thank you for teaching me about the power and the importance of education. I carry you and your words with me, every day. It deeply pains me that you never got the chance to see me graduate, and to see the fruits of your labour. But I find comfort in knowing that you are and will always be my guardian angel, and that you are wherever you are, smiling and beaming with pride. Thank you, Tlaleng Emily Dunjane for being my guiding light. I am basking in your answered prayers. Forever in my heart.

To my late parents, Nokuzola Verona Dunjane and Oupa Aggrey Dunjane, thank you for teaching me resilience. Your absence in my life from as early as my pre-teen years has brought me the deepest pain and agony, but it has also taught me how to survive in ways that I never thought were possible. I have lived up to the high academic standards you held for me as a child, and I wish that you were here to see how well it all turned out. I dedicate this achievement to you. I believe in my heart that I have made you proud.

To my little brother, Zwelibanzi Dunjane, although unbeknownst to you, you have been the reason why I have picked myself up, time and again. When I thought of giving up, I thought of you. You have pushed me to my greatest limits, all because I wanted to show you what was possible for children like us who have been through what we have been through together. May you be encouraged and find your own way. May you will reach greater heights and know that you were born for greatness.

To all my family and my friends, thank you for your words of encouragement and support throughout this journey. Thank you for your prayers. A special thanks to my dearest friend Nthavela Rikhotso, thank you for your heart that never runs dry of the most encouraging words to say. Thank you my chomie for your phone calls, they indeed kept me going.

I stand on the shoulders of giants. I am indeed my ancestors' wildest dreams!

ABSTRACT

The taxation of cross-border services has for a long time been a contentious topic of discussion across the international tax arena. The controversy of this debate stems predominantly as a result of the long held notion of the permanent establishment as a nexus requirement for source taxation; in a world where global trade, especially in services, can be significantly conducted without the need to establish a prolonged physical presence in the state of source. This is aided by digital technologies and advancements in telecommunications that enable business activities to be carried on remotely. Thus, significant economic activity can take place in a state without meeting the minimum taxable presence required to justify source-based taxation.

The problem is that with cross-border transactions between developed and developing countries, where the developing country is typically a capital-importer of services, that developing country will never have the jurisdiction to tax active service-based business income, since the threshold relied on is high, relative to how global trade is conducted today, as it is predominantly dependent on satisfying a physical presence requirement.

This study examines the nexus requirements contained in South Africa's domestic legislation for the taxation of service fee income earned by non-residents. The analysis highlights how the threshold relied on to justify source-based taxation in South Africa is high, since it requires the physical presence of the service provider within the Republic. The study further highlights how South Africa's policy choice in this regard is akin to a residence-based taxation system, by drawing parallels with the OECD model, which is renowned for its suitability to net capital-exporting and developed economies.

Alternative proxies used to tax cross-border services, as noted in the United Nation's Article 12A, the SADC Model Treaty and the domestic legislation of some BRICS member states, are introduced to the study as comparatives. The general finding hereon is that these alternative nexus requirements are predominantly akin to a policy choice slanted towards source-based taxation, contrasted by the residence-based approach evident in South Arica's policy choice.

Furthermore, the study conducts an analysis of the development of the taxation system in South Africa. The analysis reveals that South Africa's policy choice to tax active income was largely influenced by the desire to ensure that South African tax laws were internationally compatible at the time when the South African economy was reintegrated with the global economy, post-democratisation of the Republic. This led to the introduction of the permanent establishment

concept into South African domestic law, notwithstanding the knowledge of a not too distant future, where global trade would be conducted via digital technologies and telecommunications, which would render the requirement for physical presence to conduct trade obsolete.

The objective of the study is to provide policy recommendations that support a gravitational pull towards more of a territorial-based taxation system. The impact thereof is envisaged to contribute to the strengthening of South Africa's domestic source rules; the broadening of South Africa's tax base and the enhancement of the competitiveness of South Africa's economy.

LIST OF ABBREVIATIONS

Abbreviation	Meaning
DTA	Double Tax Agreement
OECD	Organisation of Economic Cooperation and Development
OECD MTC	OECD Model Tax Convention on Income and Capital (2014)
ITA	Income Tax Act 58 of 1962, as amended
SARS	South African Revenue Services
UN	United Nations
UN MTC (2011)	UN Model Tax Convention on Income and Capital (2011)
UN MTC (2017)	UN Model Tax Convention on Income and Capital (2017)

TABLE OF CONTENTS

Chapter 1: Introduction

1.1 Background

The taxation of cross-border services has been and still is one of the most controversial subjects of much debate in the international tax community on a global scale.[1] The relevance thereof comes at a time when the appropriateness and or the suitability of the current customary international tax law framework, that was typically modelled according to the OECD Model Tax Convention; for the taxation of cross-border business activities in the context of a largely digitized, globalized and technologically advanced world economy, is questioned.

From an international tax treaty perspective, the taxation of business profits by a state has typically been subject to the fulfilment of the permanent establishment requirement. This "fixed place of business" nexus or connection to a jurisdiction has historically been used as the minimum connection required before a state can exercise its jurisdiction to tax a non-resident's business profits. The use of the permanent establishment principle can be traced back to as early as the nineteenth century,[2] where business activities took place in traditional "brick and mortar" structures; hence the "fixed place of business" requirement as a minimum connection that is still used today.

The rationale for questioning the appropriateness of the current legal framework for the taxation of, especially, cross-border services stems from the fact that the rules and underlying principles thereof were crystalized at a time when the business activities of the day were typified by traditional business models, that generally required brick and mortar structures like factories and the use of extensive manual labour to carry out business operations.

However, the advent of globalization, the development of technologies and the growth of the digital economy sparked a debate across the international tax landscape about the appropriateness of the use of the permanent establishment concept as a nexus requirement, in the modern world of business;[3] in particular, the perceived irrelevance of the "fixed place of business" requirement and the decreasing need for the presence of personnel before a state

[1] F. Souza de Man, *Acknowledgements* in *Taxation of Services in Treaties between Developed and Developing Countries – A Proposal for New Guidelines* (IBFD 2017), Online Books IBFD.
[2] Y. Brauner, *OECD - Commentary on Article 5 of the OECD Model*, Topical Analyses IBFD.
[3] For a landmark discussion on the appropriateness of the permanent establishment see: A. Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle, Kluwer Law International (1992).

could exercise its jurisdiction to tax income earned by a non-resident within its territory, especially in relation to cross border trade in services.

In today's world, the advancement of modern technologies has made it possible for a business to operate and conduct its business activities without the need for a physical structure, and with limited use of human capital. These technological developments have revolutionised business models and have consequently created an array of opportunities for corporations to streamline processes and operations, to create global value chains and to take advantage of automated systems that require minimal human intervention.[4] This is particularly true for active service provider business models; as the advancements in telecommunications have rendered it almost unnecessary for the service provider to be physically present, especially for prolonged periods of time, at the place where the recipient of the service is located.

Statistics have shown a significant global increase in cross-border trade in services, in at least the last decade. Typically, most of these services are consumed by capital importing countries. These countries are predominantly developing countries, of which South Africa is one, relative to the developed economies of OECD member countries. In the current international tax framework, which is still reliant on a "fixed place of business" at a physical location and the presence of personnel as the minimum connection required to justify a state's right to tax the profits of a non-resident business, compounded by major technological developments in the way that business models and activities are structured and conducted; it is concerning that these (mostly developing) countries will never have the jurisdiction to tax active service-based business activities within their jurisdictions.

The effect of the issues highlighted above is:

1) a misalignment between the current international tax rules and the advanced modernity of business practices today; and

2) the consequential imbalance in the allocation of taxing rights between developed, capital exporting countries and developing, capital importing countries.

The underlying main cause in the author's opinion is what is currently regarded as the nexus, or the minimum connection required to justify source taxation of service fee income. In other words, the threshold used as the minimum requirement to justify source-based taxation of

[4] OECD, Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

especially cross-border service fee income, is too high and is not suited for the way in which global trade is conducted in the modern world.

While the above discussion speaks partly to the hopefully imminent reform of the current international tax framework insofar as source based taxation is concerned in general, and in particular, with regard to the taxation of cross-border services, it would however be incomplete to discuss this disproportionate allocation of taxation rights in light of the above, without an analysis of the minimum proxies or nexus requirements relied on within domestic law. While it is appreciated that treaty provisions are *lex specialis*[5] and therefore it takes precedence over the *lex generalis*[6] nature of domestic law. It is however domestic laws that create and impose taxing rights, whilst bilateral tax treaties merely allocates them.[7]

An alternative way of looking at the rationale of a focus on domestic law is that, if it can be understood that tax treaties require the sharing of taxing rights between contracting states, and that the resultant effect of the treaty is the limitation of a state's jurisdiction to tax,[8] it can then follow that an analysis of a state's domestic law can give insight into that state's unrestricted beliefs and policy objectives, in relation to the subject matter concerned.

Moreover, the argument that the current threshold for source-based taxation is too high would be somewhat baseless if the domestic law of the source state in question does not contain any thresholds or notions of nexus, as a minimum proxy to justify taxing non-residents on service income arising within that state. In this regard, this study will conduct a critical analysis of South Africa's domestic law provisions relating to how the source of service fee income earned by non-residents in South Africa is determined.

1.2 Research Problem, Research Question and Research Objectives

1.2.1 Research problem

In an attempt to address inter-nation equity,[9] the main research problem analysed in this study is that the current threshold for the taxation of cross-border services is too high, in the context

[5] K. Vogel, Chapter 1 The Domestic Law Perspective in Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), Online Books IBFD.
[6] Ibid.
[7] B.J. Arnold, Tax Treaty Monitor: Tax Treaty News, Bulletin For International Taxation (2008) at pg. 455.
[8] M. Lang, *3. The effects of DTCs* in *Introduction to the Law of Double Taxation Conventions (Second Revised Edition)* (IBFD 2013), Online Books IBFD.
[9] Prof. Dr. D. Pinto, The Need to Reconceptualise the Permanent Establishment Threshold, Bulletin for International Fiscal Documentation (2006) at pg. 270

of a technologically advanced global economy, that is less-reliant on the use of physical structures and the presence of human capital for prolonged periods of time, to conduct significant business activities in the state of source. The consequence thereof is that net capital importing and developing countries like South Africa, will never have jurisdiction to tax significant service fee income earned by non-residents within its territory.

1.2.2 Research question

The main research question is, "*how does South Africa's domestic tax law provide for the taxation of service fee income earned by non-residents*?"

1.2.3 Research objectives

The primary objective is to highlight the shortcomings of the research findings on how South Africa's current domestic source rules justify jurisdiction of tax service fee income earned by non-residents, and to present alternative recommendations in the form of a policy proposal.

The secondary objective is to use the research findings pursuant to the primary objectives of the study, with a view to highlighting the authors' perceived view of South Africa's slant towards OECD-esque, and therefore residence based taxation policy objectives, as a relatively developed country, as compared to other developing countries in Africa.

Taking these secondary objective findings into consideration, it is recommended to further propose policy recommendations skewed more towards a territorial basis of taxation, better suited for the net capital importing country that South Africa is; in an attempt to contribute to the broadening of South Africa's tax base, the strengthening of its domestic source rules and the resultant effective tax system, as envisaged by the Davis Tax Committee.[10]

1.3 Research Methodology

The research methods followed will be doctrinal,[11] reform-oriented research, and will entail evaluating the adequacy of existing rules and subsequently recommending changes to any rules

[10] Davis Tax Committee Note on Territorial Taxation, 2018, pp, 1-3. Available https://www.taxcom.org.za/docs/20180412%20DTC%20Note%20on%20Territorial%20Taxation.pdf

[11] M. McKerchar, Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation, eJournal of Tax Research (2008). Available http://classic.austlii.edu.au/au/journals/eJlTaxR/2008/1.html

found wanting.[12] This will be performed by conducting a critical analysis of South Africa's legislation and relevant case law, supplemented by a qualitative study of secondary sources of information. Research data gathered will be synthesised and appropriate conclusions will be drawn therefrom.

1.4 Delimitations of the Study

This study will focus only on the direct taxation of service fee income earned by non-residents in South Africa. The study will not consider indirect tax considerations, intra-group service transactions, services associated with royalties and related transfer pricing considerations.

1.5 Research Outline

Chapter 2 will provide a background on the theoretical fundamentals underlying the jurisdiction to tax, to provide an understanding of the principles that justify a state's tax claim. This chapter will focus on the principles underpinning source-based taxation such as the benefit theory, the concept of entitlement to tax, and the supply-demand approach, and will also include a brief discussion on the historical concept of economic allegiance. The aim of the chapter is to highlight the theoretical concepts that will be used in Chapter 6, as a basis for the policy proposal on how South Africa can justify the nexus for the taxation of non-resident service fee income.

Chapter 3 will then delve into South Africa's domestic source rules and provide a critical analysis of how the legislation currently justifies taxation for service fee income earned by non-residents. The chapter will further highlight how the current connection required to justify source taxation is aligned with residence-based taxation; typified by how it similarly aligns with the OECD's requirements for a physical fixed place of business. This chapter seeks to highlight the high threshold used for the taxation of services and consequently, the inappropriateness thereof.

Chapter 4 will look at recent international developments that have taken place regarding the taxation of cross border services, particularly the 2017 United Nations Model article on the taxation of technical services. This chapter will provide a very high-level outline of what the article seeks to achieve, and the underlying principles used to justify source taxation.

[12] T. Hutchinson, Defining and Describing What We Do: Doctrinal Legal Research, Deakin Law Review, Vol 17, No.1, 2012, pp 83-119. Available http://classic.austlii.edu.au/au/journals/LegEdDig/2013/41.html

Furthermore, the chapter will provide parallels between this new article and the policy/practices followed by some African countries on the taxation of services in their domestic law. Moreover, the research findings from the chapter will be aligned with the territorial basis of taxation. This comparative analysis aims to provide a view of alternative policy choices regarding the nexus requirements for the taxation of cross border services.

Chapter 5 will conduct an overview of the development of the taxation system in South Africa. This chapter aims to highlight how the policy choice to tax active income, and by default active service-based income, was largely influenced by the reintegration of South Africa into the global economy, and the resultant need for South Africa's laws to be internationally compatible. The analysis will also highlight how the reliance on common law principles to tax service-based income at source, which are still used today as per the discussion in Chapter 3, were regarded as inappropriate for the way in which international trade was conducted. This basis of taxation as a tax system of choice from a policy perspective, will lastly be briefly discussed in light of some of South Africa's major trading partner countries.

Chapter 6 will conclude the main findings of the study and will provide policy recommendations by advocating for a new nexus for the taxation of services, the implementation thereof feeding into the secondary objective of the study, which is to provide policy recommendations for South Africa to move more towards a territorial system of taxation. The effect thereof is contended to positively contribute to the broadening of South Africa's tax base, the strengthening of South Africa's domestic source rules, the enhancement of the competitiveness of South Africa's economy and a resultant effective tax system.

Chapter 2: Theoretical Fundamentals of Jurisdiction to Tax and the Principles Underpinning Source Taxation

2.1 The Fundamentals of Jurisdiction to Tax

The doctrine of sovereignty is an amalgam of rights and powers that a state has in exercising its authority within its geographical borders. The basis upon which a state can affect its right to enforce laws, including tax laws, justified on legitimate fiscal policy claims, is in accordance with the principle of jurisdiction.[13]

If the doctrine of sovereignty can be submitted as not being unlimited,[14] and if it can equally be submitted that the principle of jurisdiction is an aspect or an "exercise of sovereignty",[15] it can therefore follow that the extent of a state's jurisdiction to tax is limited to the extent of a state's sovereignty. The extent or the scope of a state's sovereignty is partly dependent on that state's connection or nexus to the taxable subject or to the object concerned. Connecting factors can either be personal or objective.[16]

A personal connecting factor links a taxpayer with a state, based on a taxpayer's "personal attachment" to the state. For individual taxpayers, this is typified by residence or citizenship. While the place of effective management or the place of incorporation generally represents this personal attachment to a state for corporations, this basis of taxation connotes the residence or the worldwide basis of taxation, where residents of a state are taxed on their worldwide income. This system of taxation typically grants tax credits for foreign taxes suffered on foreign incomes earned.

In contrast, an objective factor is determined with reference to the territorial principle of taxation and represents enough of a link between the geographical boundaries of a state and the economic activities or transactions arising within the territory of that state. These objective factors, determined in accordance with a state's domestic set of rules and laws, represents a state's authority to tax non-residents economic activities determined to be within the territory of that state.

---

[13] Dr. N. Tadmore, Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age, Bulletin For International Taxation (2007) at para. 2.1.
[14] Lang, supra n. 8.
[15] C. Doebbler, Dictionary of Public International Law at pg. 14. Available: https://books.google.co.za/books?id=751NDwAAQBAJ&pg=PA431&lpg=PA431&dq=omnipotent+authority+international+law&source=bl&ots=PtIW_vDkOs&sig=pgdDfERVqJUuVkfy59Qw2oyws7w&hl=en&sa=X&ved=2ahUKEwjs8tnzkZreAhXRzoUKHb8uDugQ6AEwBnoECAAQAQ#v=onepage&q=sovereignty&f=false)
[16] Lang, supra n. 8.

From the above discussion we can understand that a state's limitation to exercise its authority to tax residents and non-residents is determined in accordance with a type of unique attachment, relationship, connection, or "link" that each taxpayer has in relation to that state, which can either be subjective in relation to residents, or objective in relation to non-residents.

The focus of the study and this chapter is on the objectives connecting factors between a state and a non-resident that justifies the state's tax claim over the income of that non-resident, earned within the territory of that state, the underlying principle thereof being the territorial or the source basis of taxation. The study will look at how South Africa justifies its tax claim over a non-resident's income, earned from services rendered to residents; in other words, what set of facts or rules does South African domestic legislation provide as to whether or not a connection exists between itself and the economic activities of a non-resident, earning a service fee income in South Africa. If a connection exists, South Africa can exercise its jurisdiction to tax the income arising therefrom. If no connection exists, South Africa does not have enough jurisdiction to tax that income.

The set of rules or facts to determine whether a connection that justifies South Africa's tax claim over the income of a non-resident should be contained or not within South Africa's domestic source rules.[17]

However, because the non-resident earning an income from carrying on a business in South Africa is a resident of another country, that country (resident state) will most likely exercise its jurisdiction to tax its resident on a worldwide basis. In this case, competing tax claims exist between the territorial or the source state and the resident state, which will have the effect of causing juridical double taxation. Juridical double taxation occurs when a taxpayer is taxed twice by different states in respect of the same income.[18] It is for this reason that many states enter into "bilateral international tax conventions," widely known as double tax agreements (DTA's) with one another, to eliminate double taxation for the purposes of facilitating effective international trade.[19] DTA's effectively allocate the taxing rights between states to avoid the problem of double taxation.

Therefore, the rules governing the determination of a connection to justify a tax claim expand beyond the domestic source rules of one state in the context of cross-border trade and

[17] This will be covered in Chapter 3.
[18] See IBFD Glossary.
[19] Lang, supra n. 8.

competing tax claims between states. These rules are instead underpinned by the principles of customary international law within which double tax conventions are housed, and which have developed over time.

Thus, before delving into South Africa's domestic source rules in this regard, it is therefore worthwhile to first consider a historical overview of how the theories underpinning the allocation of taxing rights between states developed, and then secondly, what theoretical concepts have been relied on to justify source-based taxation.

2.2 The Four Economists and the Historical Concept of Economic Allegiance – A Brief History

In the early twentieth century when the incidence of double taxation increased dramatically amid an increase in global trade; in the early 1920's, the League of Nations[20] appointed a team of four economists, known as the 'Committee of technical experts on double taxation and evasion,' who were tasked to consider the issue of double taxation from a theoretical perspective.[21] The economists prepared a report titled, "Report on double taxation",[22] in which the doctrine of economic allegiance was underpinned as a general basis upon which to tax income.

The economists identified that this concept of "economic allegiance" is based on four factors or elements, intended to determine the extent of a taxpayer's relationship to an imposing authority, resulting in the determination of the place of taxation. The elements identified to effectively determine the place of taxation were as follows:

a) The origin of wealth, referring to the place where the wealth is physically or economically produced;
b) *Situs* or location of wealth, referring to the place where the final yield (product) of the process of the production of wealth is found;
c) Enforcement of the rights to the wealth, referring to the place where the rights to the wealth can be legally transferred or "handed-over"; and

[20] The League of Nations pioneered the development of model tax treaties during the 1930s and 1940s. Its works was taken over in the 1960s by the Organization for European Economic Cooperation (later the OECD) See IBFD glossary
[21] OECD (2015), supra n. 4 at pg. 25.
[22] Report available at http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;chunk.id=item-1;toc.depth=1;toc.id=item-1;database=;collection=;brand=default.

d) The place of residence or domicile, referring to the place where the wealth is spent, consumed or disposed of.[23]

Two of the four elements were the more important or were considered to bear the heaviest weight in determining economic allegiance. First, the origin of wealth, being the place where the wealth is physically or economically produced; the second being the place of residence or domicile of the owner who consumes and spends the wealth.[24]

From this we can deduce that the element of "origin of wealth", being the place where the wealth is produced is the source state, and that the basis of taxation applied is akin to the territoriality principle discussed above, where it was noted that the economic activities that produce the wealth of a taxpayer constitute an objective connecting factor in relation to the geographical boundaries of the state, within which those activities are produced.

Similarly, the element of "residence or domicile", being the place where the wealth is consumed corresponds to the state of residence of the taxpayer who enjoys the wealth produced in the source state, which is akin to the worldwide basis of taxation discussed above, whereby taxation on this basis is applied, regardless of where it was produced.

Of the two elements of economic allegiance regarded as being the most important, the one which is more relevant to this study is the place of the "origin of wealth", being the place where the wealth is physically or economically produced. For the purposes of this study, South Africa in this case, represents the place where the wealth is produced, and the activities that economically and physically produce the wealth, are the services performed by a non-resident taxpayer, which yield service fee income for that non-resident taxpayer.

Thus, the next section of this chapter will zoom into the element of the place of origin of wealth and discuss the theoretical underpinnings and principles that would support South Africa, as the place where the wealth is produced, to tax the yield (income) arising from the physical and the economic activities, in the hands of a non-resident service provider.

2.3 The Principles Underpinning the Justification for Source Taxation

While the discussion in the previous section spoke of how the jurisdiction to tax according to either the residence or to the source principle is determined, this section of the study is

[23] Ibid at pgs. 23-25.
[24] Ibid at pg. 25.

concerned with the theoretical underpinnings that justify source based taxation, and how those theoretical concepts apply to cross-border trade in services conducted; especially remotely via telecommunication methods or electronic means, or without a physical presence in the source state.

2.3.1 Benefit theory

"(source) taxation returns to the state a portion of the economic value that the state for its own part assisted in producing" – Klaus Vogel

Under the benefit theory, the rationale behind the source state's right to tax is justified by the idea that the state provides benefits, or services to taxpayers, and can therefore require a reciprocal compensation in the form of taxes.[25]

These "benefits" can range from direct, tangible services such as education (skilled labour force), police, identifiable and physical infrastructure conducive for business; to benefits that are relatively intangible and somewhat harder to trace back to a non-resident vendor operating remotely or without a fixed place of business as defined; such as a stable political and economic environment, evidenced by fiscal policies that promote growth, regulate interest rates, and exchange controls in ways that promote a thriving business environment.[26]

It can be argued that the more direct and the tangible services and benefits provided by a state are easier to trace, when enjoyed by traditional businesses with a physical presence with a degree of permanence within the source state, including the use of skilled labour. It can be equally argued that in the context of services not provided through a fixed place of business, either by electronic means or via telecommunication channels, the use of services and benefits provided by the state are much more difficult to identify and trace back to a non-resident supplier.

The extent of the "benefits" in the latter scenario can therefore be arguable as to whether source taxation is justified. In this instance, questions to consider are:

1) is the determination of economic allegiance in the state where the wealth originates a measure or quantification of benefits provided by the state of source? Or alternatively,

[25] Pinto, supra n. 9 at para 2.1.
[26] Ibid.

2) is it an indication of economic activity taking place within the geographical boundaries of the state of source, and which consequentially justify that state to impose taxation of the wealth arising therefrom?
3) does the difficulty in identifying tangible and tracing intangible benefits and services provided by a state nullify the provision or the existence thereof, and therefore the right of the source state to impose taxes on this basis?

In response to the questions posed above, Pinto[27] argues that the absence of a physical presence, that is the carrying on of business remotely, does not nullify the benefits or the services that are provided by the state. He edifies his argument by referencing Skaar[28] from one of the most well noted studies in the literature on the erosion of the permanent establishment principle, wherein he argues that: taxpayers who obtain benefits from the state should be making a corresponding contribution (in the form of taxes) to that society, whether they have a permanent establishment there or not. Pinto further concludes by stating that the benefit theory continues to be of relevance in justifying source taxation; even when non-resident vendors conduct business in the source state without maintaining a physical presence in that country. From this we can therefore conclude and respond in the affirmative to the question about whether source taxation on the basis of the benefits theory is still justified or not, and not nullified; firstly, by the lack of a physical presence, and secondly by the difficulty of directly attributing a benefit to a non-resident vendor carrying on a business without maintaining a physical presence.

In the same breath, as with the latter conclusion made in the preceding paragraph, Miller[29] concedes by saying that in many instances, state benefits are not measurable, and there should be no attempt to quantify those benefits and therefore the corresponding tax burden to be placed on the non-resident receiving them. He notes that there are state benefits that taxpayers can't avoid benefiting from, and that it is therefore simply enough that a taxpayer has enjoyed state benefits, which inextricably justifies the state to impose source-based taxation. He goes on further to quote T.S Adams in the early twentieth century, where he noted that: "a large part of the cost of government is traceable to the necessity of maintaining a suitable business environment." While the state or government relating to Adams' writing does not explicitly refer to South Africa, the principle however is that the government spends money on ensuring

[27] Ibid.
[28] A. Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle, 1991, Kluwer Law.
[29] A. Miller, Taxing Cross-Border Services: Current Worldwide Practices and the Need for Change, Online Books IBFD at para. 3.4.

an environment that is conducive to conduct business in remains consistent, and therefore undeniable for any state or cost carried by government.

Therefore, to firmly close the loop on the questions posed in the two preceding paragraphs, we can respond to question 1 by referring to the arguments raised by Miller above, noting that there are indeed benefits that are not measurable, and that those benefits cannot be denied. Moreover, that the intention is not so much to quantify the benefits as a measure of ascertaining the tax to be paid by the non-resident, but rather to show that the benefits exist and are simply enjoyed, and as a result, the imposition of taxation by the source state is justified. The author's response to question 2 is akin to the "entitlement theory," which will be further elaborated on in the forthcoming section[30] of this chapter. Lastly on question 3, regarding whether the intangible and arguably non-traceability (back to the non-resident vendor without a physical presence in that state) of state benefits such as a stable political and economic climate which creates a conducive business environment, nullifies the existence of such benefits and therefore creates a justification by the source state to impose taxes. This was addressed by reference to Pinto and Skaar, with the argument that the principle of the benefit theory remains relevant, even within the context of business carried on without a physical presence in the source state, even though arguably, those benefits might be hard to attach to a non-resident conducting business within that context.

The heart of this study is partly around the rethinking of historical methods or rules which were developed in the context of traditional business represented by offices, factories and physically present personnel, which were used as the bases of or the connecting factors to justify source-based taxation. Similarly, as with this section, it cannot be that the only way to demonstrate the benefits provided by a state is through the carrying out of business through a fixed place of business. If that is the case, it therefore follows that the theoretical justification for source-based taxation needs to be equally reformed considering the way in which businesses are carried on in the modern world today. Alternatively, those theories need to be viewed and analysed using a different lens and perspective which considers the way in which global trade is conducted today.

[30] See section 2.3.2.

2.3.2 Entitlement theory

In addition to the benefit theory discussed above, another theory underpinning source-based taxation is the entitlement theory. Under this concept, the source state is entitled to impose taxes on income and on capital originating from within its geographical territory.[31]

Following from the discussion in the preceding section, particularly in response to question 2 regarding whether economic allegiance alludes to economic activity taking place within the territory of the source state, and the corresponding justification by the state of source to impose taxes on the wealth that arises as a result of those activities; the author firstly responds in the affirmative to this question and secondly, opines that this affirmative response aligns with this very concept of entitlement. That is, economic activity within a state, not (necessarily) physical presence therein, entitles a state to impose tax on the income arising therefrom.

2.3.3 Supply-demand approach

The supply-demand approach for determining or justifying nexus in the source state was an approach contained in a report[32] produced by the OECD's Technical Advisory Group (TAG), which was mandated to "examine how the current treaty rules for the taxation of business profits apply, in the context of electronic commerce and to examine proposals for alternative rules."[33] This approach recognizes the consumer market as the place that creates the demand for services, and therefore contributes to the creation of business profits. The idea is that the provision or the availability of a market is enough proxy for source state taxation. Unfortunately, no consensus was reached as some TAG members disagreed with the notion that a market justifies the source state to tax profits derived therefrom.

The author, however, opines in favour of this approach, on the basis that there would be no continued or sustained economic activity if there was no demand for it. Without economic activity there can be no income earned or wealth produced. Without income, there is nothing for the state to tax. The viability of a business is partly dependent on the demand for its goods or services. Thus, it can be argued that it is the demand that makes the supply valuable. It can be further argued on the same basis, that the source state (South Africa) creates a demand for sustained economic activity (services) supplied by a non-resident provider operating without a physical presence in South Africa. Therefore, South Africa as the consumer market and the

[31] Pinto, supra n. 9 at para. 2.4.
[32] OECD, Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce, 2015.
[33] Ibid, pg. 1.

consequential origin of where the wealth is economically produced, has contributed to the viability of the business of the non-resident service provider. In return, South Africa is therefore justified to impose taxes on income earned by the non-resident from the provision of those services. This view ties back to the principle of economic allegiance discussed in preceding sections, which justifies taxation based on paying a debt in the form of taxes for participating in and with the economic community of a state. The author rejects the notion that no value is created by a market that provides a demand for goods and services. There are no "business profits" without consumer demand for the underlying business offering.

This view is also supported by the notion that taxation should take place where value is created.[34] The author's argument here is that value is not only created in the resident state, and therefore taxation should not only default to that resident state on the basis that home factors of production were utilized to enable the production of goods and services. While that argument is valid on its own merits, it should not take away the validity of value created by the market source state.

The debate at this point then progresses from whether there is value created in the source state or not that justifies taxation in the source state to the issue of "inter-nation equity", which talks to an equitable allocation of taxing rights between source and resident states. While an in-depth discussion of inter-nation equity is not within the scope of this study; particularly in relation to what is considered to be fair and equitable, for the purposes of this study however, the main point of contention is to highlight the fact that the market state does create value in the form of demand that contributes to the generation of income and wealth, and which consequently results in the justification to tax that income in the source state.

This argument is especially valid for the taxation of cross-border services, particularly those provided without a physical presence in the source state, as it takes away the argument that the non-resident service provider does not derive any benefit from the source state. This supply-demand approach, together with the discussion in preceding paragraphs on the intangible benefits provided by the state to non-resident service providers, even in the absence of a physical presence in the source state, aligns and remains relevant as justification for source-based taxation.

[34] OECD (2015), supra n. 4 at pg. 3

2.4 Conclusion

This chapter laid the foundation of an understanding into how a state can justify its tax claim by discussing the concept of jurisdiction. Jurisdiction accords a state the right to impose tax using either a personal, residence-based approach, or an objective, source-based approach typically applied to non-residents. The concept of economic allegiance was a physical presence within the source state.

The benefit theory discussion argued that the lack of physical presence in the source state does not nullify the presence, and therefore the enjoyment of benefits, whether tangible or not, by non-resident service providers who operate remotely.

Supporting this view was the discussion on how the entitlement theory simply justifies taxation on the basis that wealth has been generated within the territory of a state. Even supposedly without the requirement for physical presence. The argument is that economic activity which produces wealth occurs within a state, therefore that state, in exercising its powers of sovereignty, can justify the imposition of taxes on that basis.

The final discussion on the supply-demand approach to underpin source taxation, disputed the argument that the market state does not create value that justifies a state to have jurisdiction to tax. The discussion highlighted how a market state creates value by creating demand, which in turn produces the wealth of the provider.

Chapter 3 will analyse what the South African domestic law requirements are, to determine the source of service fee income earned by non-residents.

Chapter 3: South Africa's Domestic Nexus Requirements for the Taxation of Cross-border Services

3.1 Introduction

This chapter will unpack the nexus requirements relied on in South Africa's domestic law, to justify the source taxation of service fee income earned by non-residents. The objective of this chapter is to highlight how the minimum threshold required for source taxation of cross-border services is high, due to its reliance on physical presence, relative to how global trade in general and particularly in services, is conducted today. The chapter will only consider non-resident corporations and will not consider non-resident individuals in the analysis.

3.2 The Taxation of Non-Residents in South Africa

While South African residents are taxed on a worldwide basis, non-residents are taxed only to the extent where their income has its source within South Africa.[35] A non-resident company is not defined in South Africa's Income Tax Act (ITA) but is merely referred to as a legal person (other than a natural person) that is not a resident as defined. Therefore, if a legal person does not meet the criteria of a resident as defined, that person can be regarded as a non-resident. It is therefore necessary to first consider what the criteria for a resident are.

A resident (company) is defined as a person that is either incorporated, established or formed in South Africa, or a person that has its place of effective management in South Africa.[36] The concept of place of effective management is not defined in the Act, however common law guidelines provide some meaning to undefined terms. Furthermore, the South African Revenue Service (SARS) has also published an interpretation note[37] as a guideline to determine the meaning of place of effective management. The view of the SARS is aligned with the view held by the courts, and both views are aligned with OECD literature.[38]

To the extent that the legal person in question does not meet the above criteria for a resident and is not deemed to be exclusively a resident by virtue of the tie-breaker clause[39] of a treaty

[35] See section 1 of South Africa's ITA, definition of "gross income": "in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic…".
[36] See Section 1 of South Africa's ITA, definition of a resident (other than a natural person)
[37] Interpretation Note 6 of 3 November 2015. Available at (http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-06%20-%20IN%206%20Resident%20-%20Place%20of%20effective%20management%20(companies).pdf) Interpretation notes are non-binding documents which provide some guidance on the interpretation and application of provisions of the legislation. See: http://www.sars.gov.za/Legal/Interpretation-Rulings/Interpretation-Notes/Pages/default.aspx.
[38] P.J. Hattingh, South Africa - Corporate Taxation sec. 6, Country Surveys IBFD (accessed 10 Jan. 2019).
[39] The tie-breaker clause referred to is the one in accordance with Article 4 of the OECD MTC.

that South Africa has with the other contracting state, that person can therefore be regarded as a non-resident for South African income tax purposes.

3.3 Income Sourced within South Africa

3.3.1 Statutory provisions to determine the source of income

Since non-residents are only taxed on income from a source within South Africa, the next step is to determine what the source rules are in this regard.

The concept of "source" is not defined in South Africa's ITA. The determination of source is governed by both statutory provisions for certain categories of income and common law principles developed by the courts for residual categories of income that are not detailed under the statutory provisions. South Africa's statutory source rules are contained in section 9(2) of its ITA and provides that if an amount is from a source within the Republic, that the amount:

a) *"constitutes a dividend received by or accrued to that person;*
b) *constitutes interest (as defined in section 24J of the ITA) or deemed interest (as contemplated in section 8E (2) of the ITA) where that interest:*
    i. *is attributable to an amount incurred by a person that is a resident, unless the interest is attributable to a permanent establishment which is situated outside the Republic; or*
    ii. *is received or accrues in respect of the utilization or the application in the Republic by any person of any fund or credit obtained in terms of any form of interest-bearing arrangement;*
c) *constitutes a royalty that is attributable to an amount incurred by a person who is a resident, unless that royalty is attributable to a permanent establishment, which is situated outside the Republic;*
d) *constitutes a royalty that is received or accrues in respect of the use or the right of use of or permission to use in the Republic any intellectual property (as defined in section 23I of the ITA);*
e) *is attributable to an amount incurred by a person that is a resident and is received or accrues in respect of the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render, any assistance or service in connection with the application or utilization of such knowledge or information, unless the amount so received or*

accrued is attributable to a permanent establishment, which is situated outside the Republic;

f) is received or accrues in respect of the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information for use in South Africa, or the rendering of or the undertaking to render, any assistance or service in connection with the application or utilization of such knowledge or information;

g) is received or accrues in respect of the holding of a public office to which that person has been appointed, or is deemed to have been appointed, in terms of an Act of Parliament;

h) is received or accrues in respect of services rendered to or work or labour performed for or on behalf of any employer:

i. that is in the national, provincial or local sphere of government of the Republic;

ii. that is a constitutional institution listed in Schedule 1 to the Public Finance Management Act, 1999;

iii. that is a public entity listed in Schedule 2 or 3 to that Act; or

iv. that is a municipal entity as defined in Section 1 of the Local Government: Municipal Systems Act, 2000.

i) constitutes a lump sum, a pension or an annuity payable by a pension preservation fund, provident fund or provident preservation fund and the services in respect of which that amount is so received or accrues were rendered within the Republic: Provided that if the amount is received or accrues in respect of services which were rendered partly within and partly outside the Republic, only so much of that amount as bears to the total of that amount the same ratio as the period during which the services were rendered in the Republic bears to the total period during which the services were rendered, must be regarded as having been received by or accrued to the person from a source within the Republic;

j) constitutes an amount received or accrued in respect of the disposal of an asset that constitutes immovable property held by that person or any interest or right of whatever nature of that person to or in immovable property, and that property is situated in the Republic;

k) constitutes an amount received or accrued in respect of the disposal of an asset other than assets contemplated in paragraph (j) if:

i. that person is a resident, and

a. that asset is not attributable to a permanent establishment of that person which is situated outside the Republic; and

b. the proceeds from the disposal of that asset are not subject to any taxes on income payable to any sphere of government of any country other than the Republic; or

ii. that person is not a resident and that asset is attributable to a permanent establishment of that person which is situated in the Republic; or

l) is attributable to any exchange difference determined in terms of section 24I in respect of any exchange item as defined in that section to which that person is a party if:

i. that person is a resident and,

a. that exchange item is attributable to a permanent establishment of that person which is situated in the Republic; and

b. that amount is not subject to any taxes on income payable to any sphere of government of any country other than the Republic; or

ii. that person is not a resident and that exchange item is attributable to a permanent establishment of that person which is situated in the Republic."

Paragraph e) and f) relate to services that relate to royalties and the use of intellectual property which are beyond the scope of this study, and therefore do not apply.[40] The source of income from cross-border services, relevant to this study, is therefore not covered by the above statutory provisions, which mainly deal with passive income categories. The residual method to ascertain the source of income from cross-border services (and any other income not covered by the statutory provisions) is therefore to be determined in accordance with common law principles, as set out in case law developed by the courts.

3.3.2 Common law principles to determine the source of income

The landmark case that established the basis with which the courts have determined the source of income is the Lever Brothers'[41] case in which Watermeyer CJ pointed out the following:

> *"When the question has to be decided whether or not money received by a taxpayer is "gross income" within the meaning of the definition referred to above, two problems arise which have not always been differentiated from one another in decided cases. The first problem is to determine what the source from which it has been received is,*

[40] Refer to section 1.4 for delimitations of the study.
[41] CIR v Lever Bros & Unilever Ltd 1946 AD 441, 14 SATC 1.

and when this has been determined; the second problem is to locate it, to decide whether it is within the Union (South Africa) *or not.*

The word "source" has several possible meanings. In this section it is used figuratively, and when so used in relation to the receipt of money one possible meaning is the originating cause of the receipt of the money, another possible meaning is the quarter from which it is received. A series of decisions of this Court and of the Judicial Committee of the Privy Council upon our Income Tax Acts and upon similar Acts elsewhere, have dealt with the meaning of the word "source" and the inference, which, I think, should be drawn from those decisions is 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, 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 receives them. The work which he does may be a business which he carries on, or an enterprise which he undertakes, or an activity in which he engages, and it may take the form of personal exertion, mental or physical, or it may take the form of employment of capital, either by using it to earn income or by letting its use to someone else. Often the work is some combination of these."[42]

From the above statement, it can be established that the determination of the source follows a two-tiered approach. The first being the enquiry into the originating cause of the income in question; that is the activity that the taxpayer performs to earn the income. The second enquiry is the location of the originating cause, meaning the place where the taxpayer performs the activities which produces the income. In this case, the place in question would need to be within the geographical boundaries of South Africa to be considered to have a source within the Republic.[43]

The likelihood of the location of the originating cause being in more than one geographical boundary, especially within the context of globalization and the cross-functional operations of multinational corporations, was addressed in a later case, *CIR v Black*[44] which further refined the framework to establish the source. In this case, the common law principle of "dominant

[42] Ibid at 13.
[43] Hattingh, supra n. 37 at sec. 7.
[44] CIR v Black 1957 (3) SA 536 (A), 21 SATC 226.

source" was established and referred to, as the true source of the originating cause, where the main, dominant or substantial activities of the taxpayers are performed.[45]

Therefore, to determine the true source of income from cross-border services performed by a non-resident, the main or the substantial activities of the services rendered would need to be performed in South Africa for the income arising therefrom to be regarded as sourced within the Republic. Given the way in which global trade in general, and particularly in relation to services is conducted, especially in the context of a modern and technologically advanced global economy, it begs the question as to whether reliance on a "dominant source" methodology to determine the source of active (service-based) income is appropriate. The question of its appropriateness is justified based on its misalignment to current international trade practices and its susceptibility to abuse, where non-resident taxpayers (especially multinational corporations) can easily manoeuvre their global operations to avoid meeting the dominant source requirement.[46]

3.4 Tax liability of Non-residents in South Africa

Once it has been established that the income from services rendered has its dominant source in South Africa, it can therefore follow that the non-resident will be subject to normal income tax rules and will be taxed on taxable income (on a net basis) at the statutory rate of twenty-eight percent (28%), which is applicable to all companies. However, to the extent that the non-resident in South Africa is a resident of a country with which South Africa has a double tax treaty, the applicable requirements of a permanent establishment will first need to be satisfied.[47]

3.5 Conclusion

From the above analysis of South Africa's domestic source rules, the nexus requirement to justify the source taxation of income from services earned by a resident is the place of performance, that is the non-resident service provider would need to be physically present in South Africa for the income that the taxpayer earns from services rendered, to be regarded as having a source within South Africa. South Africa's domestic law policy in this regard aligns with its policy in a treaty context, where physical presence on an even higher threshold of the permanent establishment requirement first needs to be satisfied before source taxation can

[45] Hattingh, supra n. 37 at sec. 7.
[46] Katz Commission, 5th Report – Basing the South African Tax System on the Source or Residence Principle – Options and Recommendations (1997); See chapter 5 (section 5.1.2) for a further discussion on the Katz commission's negative sentiment towards the "dominant source" principle to determine the source of active income.
[47] Hattingh, supra n. 37.

apply. South Africa's treaties are predominantly modelled according to the OCED MTC. If it can be accepted that the policy of the OECD MTC favours or is akin to residence-based taxation systems, it can therefore be deduced that this is the flavour of South Africa's policy on both a domestic and on a treaty level, insofar as the taxation of active (source-based) income is concerned.

Chapter 4 will serve as a comparative base by introducing alternative nexus requirements used in some model treaties and the domestic laws of some countries.

Chapter 4: International Developments in the Taxation of Cross-Border Services and Alternative Nexus Requirements

4.1 Introduction

In Chapter 3, an analysis of the domestic source rules that determine the minimum proxy required to justify South Africa's tax claim over service fee income earned by non-residents, was conducted. This chapter will introduce alternative proxies used to justify the taxation of services at the source, with the intention to contrast and to compare the findings in the previous chapter. The bases of these comparatives will be the 2017 UN Article on technical services, the country practices/domestic legislation of some BRICS countries, and the technical services article in the SADC model tax convention. The relevance of using the BRIC and SADC countries as the bases of comparison will be briefly explained within the introduction of each respective section.

4.2 UN Model Article on Taxation of Technical Services

The purpose of this section is not intended to provide a detailed technical analysis of the provisions of the new article in the UN Model treaty on the taxation of technical services. The intention however is to highlight the nexus requirements used, and to show how the article justifies the taxation of technical services at the source. Nor is this an attempt to differentiate between the types of services that may be considered as "technical" in nature. The idea, however, is to introduce to the study, which primarily analyses South Africa's domestic rules on how the source of services rendered by non-residents is determined, an alternative basis with which source taxation for cross-border services can be justified.

4.2.1 Background

At the introduction of this study, mention was made of the topical debate on the taxation of cross-border services on a global scale. One of the notable works in this area that has emerged from this debate is the introduction by the United Nations of a new article in its Model Tax Convention (MTC), on the taxation of technical services. In contrast to the OECD MTC, the UN MTC is renowned for backing the interests of developing, capital-importing countries, by advocating for the allocation of more taxation rights to source countries; which effectively contributes to addressing the erosion of their tax bases, promotes inter-nation equity, and aids in their right to development.

The importance of the leadership role that the UN has taken is noteworthy; especially at a time where the need for consensus and consistency in the taxation of cross-border services has reached unprecedented levels. While the UN MTC is not binding on its member countries, the relevance of this new article is indisputable and nonetheless provides a basis with which the hopefully imminent reform in the current international tax framework can be relied on. Furthermore, its relevance to the study is evidenced by, as already mentioned, its stance on preserving the taxation rights of the source countries; but more importantly, because the provisions of the new article have the audacity to challenge the OECD-esque source based taxation norms that rely on a fixed place of business as a minimum threshold and has remained largely unchanged since the introduction of the permanent establishment concept in the nineteenth century.

4.2.2 The basis of taxation

Before the introduction of Article 12A in the UN Model, the taxation of income from services in the source state was restricted to the presence of a permanent establishment or a fixed base requirement, or the presence of the non-resident service provider in the source state for a period of at least one hundred and eighty-three (183) days in any twelve (12) month period.[48] This basis of taxation and its reliance on the requirement for a physical presence with some degree of permanence maintained within the source state, is reminiscent of the taxation of business profits on a net basis, in accordance with article 5 and article 7 of the OECD model.

The new UN Model article on the taxation of technical services reads as follows:

1. *"Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.*
2. *However, notwithstanding the provisions of Article 14 and subject to the provisions of Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise; and according to the laws of that State, but if the beneficial owner of the fees is a resident of the other Contracting State, the tax so charged shall not exceed ___ percent of the gross amount of the fees [the percentage to be established through bilateral negotiations].*

[48] Articles 5, 7 and 14 of UN Model (2011).

3. *The term "fees for technical services," as used in this Article means any payment in consideration for any service of a managerial, a technical or a consultancy nature, unless the payment is made:*

   (a) to an employee of the person making the payment;

   (b) for teaching in an educational institution or for teaching by an educational institution; or

   (c) by an individual for services for the personal use of an individual.

4. *The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base, situated in that other State, and the fees for technical services are effectively connected with:*

   (a) such permanent establishment or fixed base; or

   (b) business activities referred to in (c) of paragraph 1 of Article 7.

   In such cases the provisions of Article 7 or Article 14 shall apply.

5. *For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or the fixed base.*
6. *For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State, through a permanent establishment situated in that other State or performs independent personal services through a fixed base situated in that other State, and such fees are borne by that permanent establishment or fixed base."*[49]

[49] UN MTC (2017), Article 12A.

The new article imposes tax on a gross basis and recognizes the source of the service fee income in the hands of a non-resident as the place where the payer of the service fee is a resident, or the state within which the payment arises or is made. Furthermore, the article does not contain any thresholds that restrict taxation to a fixed base, nor does it require the service provider to be physically present in the source state. This is evidenced by the *lex specialis* nature of this article, which takes precedence over the generally applying source rule contained in article 7. This rule however, only applies to the extent that the non-resident beneficial owner of the service fee income does not have a permanent establishment or a fixed base in the source state, or the extent to which the services performed are not effectively connected to a permanent establishment or to a fixed base in the source state; the latter being consistent with the UN MTC's limited force of attraction rule.

As already mentioned, since the UN is known for its stance on protecting the tax bases of developing countries by allocating more taxing rights to the source state, in cross-border transactions between developed and developing countries, the payer of the service fee in this instance is therefore likely to be a resident of the developing, capital-importing state. Applying this principle to this study, South Africa in this instance, as a developing country relative to the developed nations of the OECD member countries, and a net capital importer of services, would be regarded as the place of source, being the place where the payment arises.

In contrast to South Africa's domestic rules discussed in the previous chapter, which regard the source of services rendered by non-residents to be the place where the services are performed, and therefore is limited by the need to be physically present in South Africa before source taxation can be imposed, this article's non-reliance on the physical presence element to provide services is better suited for the way in which global trade in services can take shape in the modern world today; whether remotely via telecommunications, e-commerce or other digital technologies. In this way, cognizance of the possibility of significant participation in a country's economic community without the need to be physically present therein, is therefore acknowledged and addressed.

4.3 BRICS

The BRICS countries are made up of Brazil, Russia, India, China and South Africa. The grouping of these countries described as "emerging economies" was based on their respective rise in economic power and performance, as indicated by their collective share of the world's

GDP.[50] During this time, South Africa was not originally included within this group previously referred to as the BRIC, but was only admitted in 2010, as something of an African representative amongst the world's growth markets.[51]

The relevance of using some of the BRICS countries' domestic legislation as a basis of comparison is based on the premise that this group of countries is, to some extent, a bridge between the traditional developed and developing countries. Therefore, for the purposes of the study, it would be of interest to note to which end the pendulum swings between domestic policies akin either to the developed country, being residence-based taxation or, in a developing country, being source-based taxation. Each country's domestic nexus requirements for the taxation of services will be briefly highlighted, and then compared with the UN Model's Article 12A and South Africa's domestic law. Contradistinctions to the OECD model will also be made where appropriate.

4.3.1 Brazil

Non-residents deriving fee income from the provision of services without a physical presence in Brazil are subject to a gross based withholding tax at a rate of twenty-five percent (25%). However, to the extent that the services provided are technical services or relate to management fees, the rate is reduced to fifteen percent (15%). Furthermore, to the extent that the fee is paid to a service provider located in a tax haven, the withholding tax rate imposed is twenty-five percent (25%). Therefore, the taxable event, that is the connection or minimum requirement to justify source taxation of service fees paid to non-residents is the payment obligation from a source within Brazil.[52]

Conclusively, the threshold to determine taxable presence to justify source taxation of service fee income derived by non-residents in Brazilian domestic law is lower in comparison with South Africa's place of performance rule and significantly lower than that of the OECD's permanent establishment requirement but it is on par with the UN Article 12A thresholds discussed above. Both Article 12A and Brazil's domestic law impose source taxation of service fees on a place of payment or on a residence of the payer basis. Brazil's laws in this regard (and the alignment thereof with the UN's Article 12A) come as no surprise, given that it is

[50] J. O'Neill, *Building Better Global Economic BRICs*, Global Economics Paper 66 (2001), pg. 3 (available at https://www.goldmansachs.com/insights/archive/archive-pdfs/build-better-brics.pdf).
[51] P. Pistone & Y. Brauner, *Chapter 1: Introduction* in *BRICS and the Emergence of International Tax Coordination* (Y. Brauner & P. Pistone eds., IBFD 2015), Online Books IBFD.
[52] V. Arruda Ferreira, *Brazil - Corporate Taxation* sec. 7, Country Analyses IBFD (accessed 17 Dec. 2018).

indeed a developing country and a net-capital importer of services, with a focus on preserving its right to tax cross-border income and on protecting its tax base from potential base erosion. The latter is particularly evidenced by the lower threshold required for taxable presence, and the higher withholding tax rate imposed for payments to non-resident persons in low-tax jurisdictions.

4.3.2 India

India's domestic law for the taxation of non-residents uses the concept of a "business connection," as a nexus to justify source taxation. This concept is like a permanent establishment, but a lot broader, and therefore requires a relatively lower threshold in comparison. Effectively, this concept of a business connection recognises the need for there to be significant business activities carried on in India (as opposed to once-off transactions). The rules to determine whether a business connection exists or not are not exhaustive and are to be determined on the facts of each case.[53]

According to section 9(1)(vii)[54] of India's ITA, the source of service fee income derived by non-residents is deemed to arise in India, and is therefore subject to tax in India, if it is paid by the Indian government or an Indian resident; unless those services are for the benefit of a business carried on by that resident payer outside of India. This source rule applies even if the payer is a non-resident, to the extent that those services are utilized for the benefit of a business carried on by that non-resident in India. This rule is consistent with the UN's Article 12A (6) and Brazil's residence of the payer or place of payment principle, as a determinant of the source.

Furthermore, as with the lack of physical presence thresholds in article 12A and Brazil's domestic rules, India's rules similarly do not provide that the services be rendered physically in India to justify source taxation. Therefore, the requirement for a fixed place of business is not necessary to determine taxable presence in the source state. In 2010, this rule was further clarified by an amendment to the explanatory commentary to section 9 of India's ITA, which was made following a case[55] in 2007 in which the Supreme Court observed that the taxation of income arising from service fees rendered by non-residents under section 9(1)(vii) applies only to the extent where services are utilized in India and rendered in India. The amendment to the

[53] S. Shah, *India - Corporate Taxation* sec. 7, Country Analyses IBFD (accessed 17 Dec. 2018).
[54] Available at https://indiankanoon.org/doc/492579/ (accessed 17 December 2018).
[55] *Ishikawajima-Harima Heavy Industries Ltd.*, ((2007) 288 ITR 408).

explanation to section 9 clarified the intention of the legislation to tax service fee income rendered outside of India, if those services are utilized in India.[56]

From the above analysis of India's domestic source rules in section 9 of its ITA, including the associated explanation to the section, it can be concluded that the minimum proxies for the taxation of service fee income derived by non-residents in India are:

1) the resident of the payer/place of payment principle; and
2) the utilization principle.

The latter is the first anomaly of nexus norms used, in comparison to South Africa's domestic law, the UN Article 12A and Brazil's domestic law.

4.3.3 China

Of the three BRICS countries considered in this chapter, China is the only one with domestic source rules that do not deviate from the OECD orthodoxy, insofar as the nexus required for the taxation of service income derived by non-residents is concerned. Service fee income derived by non-residents in China is treated similarly to business profits in the OECD model treaty and is therefore subject to tax in China to the extent that the non-resident carries on a business in China through a permanent establishment. Thus, reference to the OECD orthodoxy on the taxation of service fee income in this section can therefore be synonymous with China's tax treatment of the same income.

Having this in mind, it can therefore be said that while South Africa's place of performance as a nexus requirement as discussed in Chapter 3 is at a lower threshold compared to the OECD's fixed place of business proxy, its requirement for the physical presence of the service provider in the source state is nonetheless comparable and similar to the requirement for a physical presence in the source state; albeit without the additional requirement for it to be over a prolonged period of time.

4.3.4 BRICS conclusion

Of the four BRICS countries considered in this study, Brazil and India's nexus requirements for the taxation of cross-border services rely mainly on the payment principle, while China and South Africa rely on the physical presence of the service provider to determine the source.

[56] Shah, supra n. 52.

Brazil's and India's policies were likened to the UN's Article 12A, while China and South Africa's domestic policies were likened to that of the taxation of business profits in accordance with the OECD model, the provisions of which are renowned to better suit developed countries.

Insofar as China and South Africa's policy choices are concerned, in contrast to South Africa, China is one of, if not the largest manufacturer in the world and a dominant global service provider. The size of China's economy, the size of its contribution to the world's GDP and various other factors that sets it far apart from South Africa's economy, could perhaps justify its residence-based domestic policy stance on the taxation of cross-border services. There may be a myriad of reasons, the analysis of which is beyond the scope of this study, that may uphold China's policy choice in this regard. However, the reasonability or the appropriateness of South Africa's policy choice in the author's mind, remains rather questionable.[57]

4.4 SADC

The Southern African Development Community (SADC) is a regional intergovernmental body with sixteen member states, of which South Africa is a member.[58] The objective of this community is to promote socio-economic co-operation and inter-regional integration amongst its members. The SADC community also has its own model tax convention, the provisions of which are followed in practice by some of its member countries, even though the final draft has not yet been signed and is therefore not yet in force.[59]

The use of the SADC regional community as a basis of comparison is intended to highlight how South Africa's policy on the taxation of cross-border services diverges or converges; relative to its fellow regional partners. The common denominator relied on between South Africa and the rest of the SADC countries is generally the collective developing nature of most of the economies represented in the SADC, especially when compared with the rest of the developed, OECD member countries. The SADC model is also used as a treaty representation of the domestic practice and domestic legislation of most African countries, regarding the tax treatment of cross-border services.

[57] See section 4.5 on the point regarding the extent to which South Africa should be leaning towards either the residence-based or source-based system of taxation.
[58] See SADC website available at https://www.sadc.int/about-sadc/
[59] P.J. Hattingh, Chapter 8: South Africa in BRICS and the Emergence of International Tax Coordination (Y. brauner & P. Pistone eds., IBFD 2015), Online Books at 8.2.2.

4.4.1 Basis of taxation

The SADC model shows various deviations from the OECD Model, the analysis of which are beyond the scope of this study. What is important to mention however is that South Africa agrees with these deviations, save for one very contentious issue; the taxation of services at the source.[60] The SADC model, like the UN Model, but in contradistinction to the OECD Model, contains a separate article dealing with the taxation of technical services. The article provides for the gross taxation of service fee income at the source, which is the payer's state of residence and the payment arising principally discussed in accordance with the UN's Article 12A above. South Africa's domestic policy in this regard however, as discussed in Chapter 3 of this study, is underpinned by a physical presence as a nexus requirement, where the source of service fee income is at the place where the services are rendered, and therefore taxed therein on a net-basis. Therefore, South Africa's domestic law policy in this regard carries through to the model treaty in that it has reserved its right to not include the article.

The alignment in the treaty policy of services in the SADC model and the UN model should come as no surprise. This assertion is qualified on the basis that the representative countries[61] in the SADC are in the majority developing, capital-importing African economies; at which the objectives of the UN model to promote source-based taxation model are aimed. The fact that their model policy deviates from the resident-state-favouring OECD model in a similar way as the UN model does, proves this point.

Furthermore, both the UN and the SADC model's treaty policy on the taxation of services mirror the domestic practice of many African jurisdictions that impose withholding taxes on service fee income, using the residence of the payer or the payment arising principle as the nexus requirement to justify source taxation. This imposition of withholding taxes often occurs, regardless of a treaty providing otherwise, and could perhaps be an indication of a somewhat forced extension of what their respective domestic laws provide.[62]

4.5 Conclusion

In comparing South Africa's nexus requirement rules for the taxation of cross-border services to the UN's Article 12A, the BRICS countries, and the SADC model article (including the

[60] Ibid.
[61] The other member states of the SADC are Angola, Botswana, Comoros, Democratic Republic of Congo, Eswatini (Swaziland), Lesotho, Madagascar, Malawi, Mauritius, Mozambique, Namibia, Seychelles, Tanzania, Zambia and Zimbabwe. See SADC website, supra n. 57.
[62] Explanatory memorandum to the Taxation Laws Amendment Bill 2011 at 4.2.3.

assertion of the SADC model being a representation of the domestic practices of many African countries), it is clear to see how South Africa's policy choice in this regard, on both a domestic and model treaty level, stands out as the only country – bar China - that diverges in favour of physical presence as a nexus requirement, to justify source taxation. As discussed in the previous chapter, this policy choice is more akin to a residence-based system of taxation and is also consistent with South Africa's treaty practice whereby, bar some minor deviations, most of South Africa's treaties are patterned according to the OECD model.[63]

While it may be argued that, from the perspective of South Africa being more of a capital-exporting country compared to other African economies, the policy choice of favouring residence-based taxation may be justified. However, a study of South Africa's tax system over a hundred (100) year period between 1914 and 2014 asserted that there is no evidence to support where South Africa should be on the pendulum between source-based and residence-based taxation systems.[64]

Therefore, in the absence of evidence to the contrary, it is therefore questionable to what extent, if at all, does South Africa position itself as a capital-exporting country relative to its African neighbours. This is probably more beneficial than adopting policy choices that support and that promote a source-based system of taxation.

[63] Hattingh, supra n. 58 at 8.2.1.2.
[64] J. Hattingh; J. Roeleveld; C. West, Income Tax in South Africa, the First 100 years 1914-2014, Juta Law (2016) at pg. 274.

Chapter 5: The Development of the Basis of Taxation in South Africa, and International Trends in the Use of Source or Residence-Based Taxation Systems

5.1 Introduction

In the previous chapter, alternative proxies relied on to tax cross-border services were introduced in the study as the bases to compare against the nexus requirements used in South African domestic law. The findings revealed contrasting policy choices between South Africa's domestic legislation, the UN Model's Article 12A, the SADC Model article on technical services, and Brazil and India's domestic legislation on the taxation of cross-border services. These findings further highlighted by contrast, South Africa's domestic policy choice on the taxation of cross-border services as being slanted towards a residence-based taxation system.

The previous chapter concluded by mentioning a study conducted on income tax in South Africa over a one hundred (100) year period, which found that while South Africa currently exhibits a hybrid taxation system, there is no concrete evidence nor any clear policy objective that supports where exactly the South African tax system should be, between the two extremes of either a residence-based or a source-based system.[65]

This chapter will provide, an overview of the development of the basis of taxation in South Africa, with the intention of highlighting how the policy to tax active income at the source was influenced by their objective to reintegrate South Africa into the global economy.

Furthermore, the chapter will also highlight how, the introduction of the worldwide basis of taxation was introduced into South Africa, that the source-based system was left behind the development curve, while the residence-based system was being rigorously bolstered amid concerns of tax avoidance by residents. Insofar as the eventual enhancements to the source-based rules are concerned, the chapter will highlight how these enhancements predominantly focused on passive income streams, rather than active income.

Lastly, the chapter will consider some international trends in the use of either the residence-based or the source-based system of taxation, with a focus on some of South Africa's major trading partners.

[65] Ibid.

5.2 The Development of the System of Taxation in South Africa

5.2.1 A history of commissions – A series of investigative analyses of the appropriate tax system for the South African economy

The first income tax laws in South Africa were based on the territorial (source-based) taxation system. As already discussed in Chapter 2, the source-basis of taxation, or the territorial principle of taxation justifies the taxation of income arising within the geographical borders of that state, regardless of the residence of the recipient of that income.[66]

For various reasons, several commissions were deployed to advise on the suitability of a source-based taxation system for the South African economy at the time. In 1951, the Steyn Committee was in favour of retaining the source-based tax system, on the basis that a switch from a source-based to a residence/worldwide basis of taxation would be complex and would result in only a marginal increase in tax revenue.[67]

In contradistinction to the Steyn Committee, in 1970 the Franzsen Commission recommended a switch to a residence-basis of taxation amid concerns of increasing income flows into South Africa that were escaping the tax net. The Commission also held that South Africa had already deviated from a pure source-based tax system; as evidenced by various deeming provisions in the legislation at the time. Despite the recommendation, no change in the tax system was implemented.[68]

In 1986/1987, the Margo Commission submitted its recommendation, like that of the earlier Steyn Committee[69], to retain the source-based taxation system. Its recommendation was however subject to an extension of the existing deemed source provisions prevailing at the time. On the other hand, however, the Margo Commission further noted several reasons that would favour or would justify a residence-based tax system. In that regard, it noted the positive effects that a lift in the exchange control regulations would provide as well as a corresponding greater ability of a residence-based system to curb tax avoidance schemes. Notwithstanding that, it expressed that the transition to a residence-based system would not yield significant benefits to justify the move. As a result, the South African tax system retained its source-basis,

[66] See section 2.1 of this study for the discussion.
[67] Katz Commission, supra n. 45 at 2.1.1.
[68] Ibid at 2.1.2.
[69] Katz Commission, supra n. 45 at 2.1.1.

which included an extended version of various deemed source provisions and was therefore representative of more of a hybrid system, than a purely source-based system.[70]

5.2.2 The reintegration of South Africa into the global economy

In its 1987 report, the Margo Commission expressed the need for the South African economy to create an environment conducive for trade and for investment. The post-apartheid democratization of the South African economy in 1990 peaked the flow of international trade and investment into South Africa and to some degree, signalled the reintegration of South Africa into the global economy.[71] Prior to that, South Africa had experienced sanctions from the international community, and was barred from participating in cross-border trade due to its racial segregation laws. This, among other reasons and consequences meant that South Africa was left behind the curve when it came to the development of tax laws that dealt with cross-border transactions.[72]

In 1997, the Katz Commission was appointed to conduct an investigative analysis of the tax system of South Africa from the new perspective of an economy now immersed in global trade.[73] This project, in the author's mind, was the first of a few that set the tone for the reform of South Africa's tax system as it existed at that time.

In its report, with the objective of finding an optimally balanced taxation system, the Katz Commission detailed several factors that it took into consideration in its analysis. These factors included:

i. the basis of tax most suitable for the generation of tax revenue;
ii. neutrality and administrability as basic tenets of a good tax system;
iii. the objective of establishing South Africa as a headquarter gateway for regional and inter-continental trade and investment, as well as the tax system most suitable to meet this objective;
iv. anti-avoidance measures such as controlled foreign company rules;
v. considerations concerning exchange control regulations; and
vi. ensuring that South Africa's laws are internationally compatible.[74]

[70] Ibid at 2.1.3-2.1.5.
[71] Ibid at 2.2.1.
[72] Hattingh et al, supra n. 63 pg. 256.
[73] Ibid.
[74] Katz Commission, supra n. 45 at sec. 3.1 – 3.2.

Regarding the internationalisation of South Africa's domestic law concepts and terms, the Commission expressed the need to distinguish between active and passive income, and to tax active income on a source basis, and passive income on a worldwide basis, through deeming provisions. Throughout the report, the Commission stressed several times[75] (author's emphasis), the importance of ensuring that the system should use internationally recognized concepts as far as possible, to ensure South Africa's much desired integration with the global economy.

Insofar as the Commission's recommendations relate directly to this study regarding the taxation of active (service-based) income, the Commission guarded against the introduction of a detailed source of location rules for active income. To this end, the report instead noted in favour of: *"...guidelines which are generally used internationally, and especially in the treaty context, should be incorporated into our law. This will greatly enhance clarity and therefore international compatibility."*[76]

In this regard, the Commission noted the international trend across various national systems and international tax treaty laws, on the reliance of the permanent establishment concept as a basis to tax active income at source. On this basis, the Commission recommended the introduction of the permanent establishment concept into South African tax law, as a nexus to tax cross-border active income.[77]

What is interesting to note is that, even at that time, the Commission was also aware and had equally made a note in its report, of a not too distant future, where the form in which global trade will take shape would be influenced by e-commerce and the internet. In this regard, it rightly foresaw and noted the possibility of the "irrelevance of physical presence" to conduct trade in the "electronic future," and the corresponding impact it would have on the (in)appropriateness of the fixed nature of the permanent establishment concept.[78]

The Commission's sentiment regarding the irrelevance of physical presence to conduct trade in a digital and globalized world, and the consequential redundancy of the permanent establishment concept is very much at the heart of this study. What was imminent then is reality now. However, the report dismissed this inevitability on the basis that the Commission had not found any international precedent that dealt with this likelihood. The report further notes that

[75] Katz Commission, supra n 45 at sec 3.1.5, 3.2.2, 3.2.4-3.2.6, 4.1.1, 5.1.2.
[76] Ibid at sec 3.2.6.
[77] Ibid at 5.3.1.
[78] Ibid at 7.4.1.

the Commission was not comfortable taking a pioneering role in the matter at the time. To this point it noted: *"... it would be premature now to introduce an entirely new regime of international taxation which seeks to cope with these (electronic) developments; indeed, to seek a pioneering role here would be both arrogant and dangerous."*[79]

While the author agrees with the Commission's decision not to take the lead on addressing what was viewed as an international matter that would likely "affect all economies," this "development" has now reached a point where it can no longer be swept under the carpet. Its impact has developed to such an extent that the United Nations together with its MTC, albeit not in a binding document, has taken an admirable leadership role to reach some international consensus on the treatment of cross-border service-based active income, through the introduction of a new article on technical services.[80]

The author notes with interest, that the Commission's praise and recommendation in favour of the international concept of the permanent establishment was juxtaposed against its discontent with South Africa's tax laws, regarding how to determine the source of active income at the time. In this regard, the report noted that the system had no clear guidelines to determine the source of income in general, and specifically in relation to active income. It further expressed its dissatisfaction with the system's reliance on the courts for the determination of the dominant source, noting it as an "uncodified system," which creates uncertainty for foreign investors, is susceptible to abuse, and is not in alignment with international trade.[81]

Surprisingly, while the Commission was against the use of the dominant source rule to determine the source of active income, that rule is still present in South Africa's tax law today.[82] Similarly, its recommendation for the introduction of the permanent establishment requirement eventually made its way into South Africa's domestic tax laws, as was discussed in Chapter 3 of this study.

[79] Ibid at 7.4.2.
[80] For a discussion on the UN article on technical services, see section 4.2.
[81] Katz Commission, supra n. 45 at 5.2.1.
[82] See sec 3.2.2.

5.2.3 The introduction of the worldwide basis of taxation in South Africa

The Revenue Laws Amendment Bill of 2000 noted that legislative measures would be introduced to change South Africa's source-based system to a residence (worldwide) system as from the year of assessment commencing 1 January 2001.[83]

The Katz Commission's report discussed in the preceding section had several indicators of an impending gradual move towards a worldwide system of taxation. In fact, the executive summary of the report noted that South Africa's tax system was then primarily based on a source basis, and that it had already adopted some measures associated with the worldwide system of taxation. Therefore, it noted that expanding these worldwide bases of taxation measures would not be materially complex to implement. The body of the report also mentioned factors related to a worldwide system, such as the relaxation of exchange control regulations and the introduction of anti-avoidance measures such as the introduction of CFC rules, to name a few.[84]

The report also noted that the primary function of a tax system is to raise revenue, and that the worldwide system would be better suited to meet this objective.[85] One can therefore say that the introduction of the worldwide system of taxation in South Africa was somewhat inevitable.[86]

Since the introduction of the worldwide basis of taxation in 2001, a lot of emphasis was placed on bolstering anti-avoidance measures for outbound transactions by residents. These included the strengthening of controlled foreign company legislation, transfer pricing and thin capitalization provisions as well as the tightening of specific rules dealing with the taxation of income from offshore trust structures. While these rules were being amplified, the rules pertaining to the source basis of taxation (which applies to non-residents) were neglected, with not much done to strengthen them. This therefore meant that the tax laws applying to residents were much more onerous than they were for non-residents.[87]

[83] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000 at pg. 2 available http://www.treasury.gov.za/legislation/bills/2000/rlam_memo.pdf.
[84] See FN 74.
[85] Ibid at 3.1.1.1.
[86] Hattingh et al, supra n. 63 at pg. 257.
[87] Ibid at pg. 261.

5.2.4 Refining the source rules of taxation

A decade after the introduction of the worldwide basis of taxation, a few amendments were made to refine the source rules amid concerns of uncertainties caused by differing interpretations under the common law principle of the originating cause. The 2011 amendment laws therefore proposed changes that had the effect of eliminating deemed source provisions, limiting the use of common law principles to determine the source, and aligning some rules to determine the source in accordance with treaty principles. The proposed amendments were set to come into effect after for years of assessment and commenced on 1 January 2012.[88]

The main types of income that were no longer to be determined in accordance with the common law principles were the typical passive income streams.[89] The proposed amendments aligned the determination of source for these passive income streams in accordance with the OECD tax treaty principles. The common law principles that previously applied were now limited to being used as a residual method applied to categories of income not falling within the passive income streams as described above.[90]

Insofar as the source of active income was concerned, not much was done to refine these source rules. However, in relation to income from services, the proposed amendment noted that the determination of the source for services would remain unchanged and would still be based on the common law doctrine of originating the cause and the dominant source. Therefore, the place of performance remained as the nexus requirement for source taxation of cross-border services.

Following the 2011 proposed amendments to the source rules, the source rules were further enhanced from 2012, when South Africa increased the types of withheld taxes levied.[91] Once again, this development relates mostly to passive income in the form of interest, dividends and royalties, to name a few. This therefore reinforces how the source rules in relation to active income have not been given much attention, notwithstanding the concerns raised by the Katz Commission in 1997[92], on the future irrelevance of the physical presence requirement to conduct trade and thereby to determine the source, as well as the uncertainties caused by and

[88] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2011 at sec 4.2.
[89] The types of passive income streams referred to include dividends, interest, royalties, foreign exchange differences and capital gains from immovable property.
[90] See sec 3.2.2. for the discussion on the common law principles relied on to determine the source of income.
[91] Hattingh et al, supra n. 63 at pg. 265.
[92] See sec 5.1.2.

the inappropriate reliance on, the common law principle of dominant source, relative to the realities of international trade.

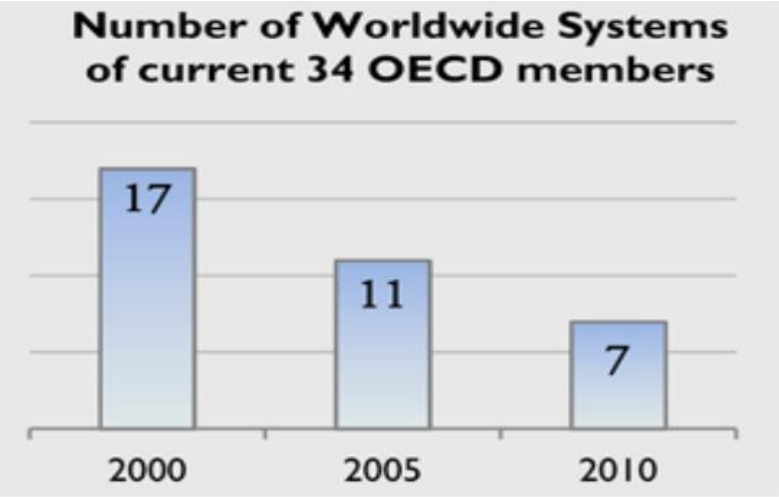
5.2.5 International trends on the use of the worldwide and source-based system of taxation

The application of the worldwide and the source-basis of taxation across nations around the world is usually in a hybrid format representing features from both systems, rather than a pure system based entirely on one or the other.[93]

While there are a number of factors such as a country's administrative capacity, net cross-border capital inflows and economic strategies that determine the appropriateness of a tax system[94], seems rather interesting, to the author, that the majority of the OECD member countries follow a territorial system of taxation.[95] It is interesting because the OECD model's treaty policy is renowned for being akin to a residence-based system which is better suited for capital exporting and for developed countries. Meanwhile, from a domestic tax system perspective, these developed, and mainly capital exporting countries mainly follow a territorial system of taxation, which is often associated with developing, capital importing countries.

The following graph, Figure 1 below, shows the decreasing trend of OECD countries using the worldwide system since the year 2000. Thereafter, Table 1 shows the year in which some countries transitioned from a worldwide system to a territorial system.[96]

Figure 1



[93] Katz Commission, supra n. 45 at 1.3.1, 1.3.4.
[94] Ibid at 1.3.6.
[95] P. Dittmer, A Global Perspective on Territorial Taxation, 2012 Available https://taxfoundation.org/global-perspective-territorial-taxation/#_ftnref9 .
[96] Ibid.

Table 1

Territorial Systems	Transition Since 2000	Worldwide Systems
Australia		Chile
Austria		Greece
Belgium		Ireland
Canada		Israel
Czech Republic	2004	Korea
Denmark		Mexico
Estonia	2005	United States
Finland		
France		
Germany		
Hungary		
Iceland	2003	
Italy		
Japan	2009	
Luxembourg		
Netherlands		
New Zealand	2009	
Norway	2004	
Poland	2007	
Portugal		
Slovak Republic	2004	
Slovenia		
Spain		
Sweden		
Switzerland		
Turkey	2005	
United Kingdom	2009	

Of the countries that transitioned from a worldwide system to a territorial system in Table 1 above, two are some of South Africa's major trading partners. Japan and the United Kingdom that both transitioned in 2009, amid collective concerns and objectives around strengthening domestic competitiveness of corporations and the high compliance costs associated with the worldwide system. A study of Japan's system found that the transition from a worldwide source-based tax system reported an increase in corporate tax receipts and in dividend repatriations. Similarly, a study of the United Kingdom's tax system conducted in 2012 indicated that the transition from a worldwide system to a territorial system resulted in a six percent (6%) increase in tax revenue.[97] While it can be argued that correlation is not causation,

[97] Hattingh et al, supra n. 63 at pgs. 270-271.

it cannot be by accident that some of the world's largest economies have gravitated towards, if not already transitioned to, a source-based system of taxation.[98]

5.3 Conclusion

The preceding discussion has highlighted several factors relevant to this study. The first is that the internationalization of South Africa's laws was of paramount importance to meet the objective of creating an open economy for South Africa that was conducive to global trade. Hence, amongst other things, the introduction of the permanent establishment as a nexus requirement to tax active income and the recommendation against the use of detailed source of location rules for active income.

Secondly was the Katz Commission's awareness of a not too distant future that would render the requirement for the physical presence irrelevant to conducting trade. This likelihood did not however make the Commission retract its recommendation. Instead, the main reason it cited was that it was not in South Africa's best interest to take a pioneering role to re-engineer the trend of international tax law at the time.

Thirdly discontent was expressed towards the use of the dominant source rule to tax active income. The Commission noted it as an un-codified system that is susceptible to abuse and is not reflective of the realities of international trade. As discussed in Chapter 3 of this study, this residual method of determining the source of service-based income is still relied upon in South Africa's domestic legislation today.

Furthermore, the chapter noted how, due to economic sanctions, South Africa was left behind the curve in terms of laws dealing with cross-border transactions. It was further highlighted that the source rules were only refined in 2011, a decade after the introduction of the worldwide system of taxation. This meant that, while some of the world's largest economies were transitioning to a source-based taxation system, South Africa was instead focused on bolstering its anti-avoidance laws, thereby making the tax system more onerous for residents than non-residents.

Lastly, this chapter highlighted how the eventual enhancement into South Africa's source rules were mainly focused on passive income being subjected to the withholding of tax. This further highlighted that the policy regarding South Africa's domestic source rules in relation to the

[98] Dittmer, supra n. 94.

taxation of active income has not changed since the recommendation by the Katz Commission to internationalise the laws, at a time when South Africa needed to reintegrate itself with the global economy. In other words, the policy choice, which is still reflected in South Africa's domestic law today, is still based on a policy objective that was established in 1997.

By extension, this chapter has also highlighted that the source of service-based active income, has remained unchanged since the development of the common law principles of the originating cause and the dominant source, which originated in 1946 and 1957 respectively.

Chapter 6: Conclusion

6.1 Concluding Remarks – Main Findings of the Study

The objective of this study was to highlight the shortcomings of South Africa's domestic nexus requirements for the taxation of cross-border service fees. The findings of the study indicated that South Africa's domestic policy relies on the physical presence to determine the source of income from cross-border services. This policy choice was further likened to a policy that typifies a residence-based taxation system, often associated with the OECD MTC and its developed member countries, partly due to its distributive rules that allocate taxing rights predominantly towards the state of residence.

South Africa's domestic policy contrasted against the UN MTC's Article 12A and its fellow BRICS and SADC constituents revealed how South Africa's policy stood out as the only country who relied on physical presence to determine the source of cross-border services. China's policy on the other hand, while it mirrored South Africa's policy, was excused based on being one of, if not the world's largest manufacturer, and that could, amongst other reasons, justify its policy choice in this regard. The comparative study further revealed that the policy of the SADC MTC from both a treaty perspective and as a representative of the domestic practices of many African countries was consistent with the policy of the UN MTC's Article 12A. As with Brazil and India, their respective domestic policies revealed the same consistency with the UN MTC's Article 12A. This finding highlights how the policies of some of the world's largest emerging economies represented by Brazil and India, including the traditional developing African economies represented by the SADC are aligned with the source-based taxation system as evidenced by the consistencies with the UN Model which is renowned for its distributive rules which seek to allocate more taxing rights to the state of the source.

The study highlighted how the use of the physical presence to locate the source of income has lost its relevance in a globalized and digitally advanced world, where international trade practices show significant activity can take place within a state, without physical presence and therefore without creating a taxable presence.

The theoretical principles underpinning source taxation revealed how the source state can still justify its tax claim over cross-border services, even without fulfilling the physical presence requirement. These theories, together with the alternative proxies used as a comparative to

justify source taxation of cross-border services can be used conjunctively from a policy perspective, to reimagine the source of cross-border services in South Africa.

A brief overview of the development of the taxation system in South Africa revealed that the policy to tax active income was premised based on South Africa's need to reintegrate with the global economy, post-democratization. This analysis further revealed how the imminence of the digital future was foreseen at the time when the internationally compatible concept of the permanent establishment was recommended to be introduced into South Africa's domestic law. Notwithstanding the foresight of the future irrelevance of the physical presence to locate the source, the reason to not have addressed it at that time was due to the lack of international precedence that sought to address this phenomenon. However, over two decades later, while an unbinding document, the UN MTC has indeed begun to set a precedent within an arena of international taxation that is in dire need of international consensus. The broad spectrum of nexus requirements used in the domestic laws of global nations is somewhat evidence of a policy choice by states, rather than on maintaining an unattained standard of international compatibility.

Finally, the study highlighted that while South Africa was bolstering its worldwide system of taxation, the rest of the developed world, including some of its major partners were transitioning to a source-based system of taxation, citing studies of increased tax revenues and levels of dividend repatriation. Moreover, the study found that South Africa's domestic source rules for the taxation of cross-border services are based on a methodology that relies on common law principles that were established between the 1940's and 1950's and have remained unchanged since.

Furthermore, the study revealed that there is no evidence in the form of clear policy objectives that indicate where South Africa's taxation system should gravitate towards, between the worldwide or the source-based taxation system.

6.2 Recommendations – A Policy Proposal

South Africa should revisit its domestic source rules for the taxation of cross-border service income. The methodology to determine the source of cross-border income is based on common law principles that are susceptible to abuse and are not aligned with international trade practices. The domestic nexus requirements that place reliance on physical presence should be revisited based on the principles underpinning source-based taxation as discussed in Chapter

2. The discussion on these theories revealed that physical presence is not a necessary concomitant to justify source-based taxation, even from service-based active income.

Moreover, the comparative domestic law policies and model treaties highlighted alternative proxies that South Africa can instead consider in its policy regarding cross-border services. Lastly, given the lack of evidence in the form of clear policy objectives to justify South Africa's position between a worldwide or a source-based taxation system, it is therefore recommended that South African policy makers study the trends of developed economies transitioning into source-based systems, and to consequently adopt policy choices that support and that gravitate towards the source-based system of taxation.

This policy proposal is based on the premise that the adoption of a few more policy choices that are representative of a source-based taxation system will assist in contributing to the strengthening of South Africa's domestic source rules, which will aid in an increase in tax revenue and will enhance the competitiveness of South Africa's economy.

Bibliography

A. Ferreira, Brazil - Corporate Taxation sec. 7, Country Analyses IBFD (Accessed 17 December 2018).

A. Miller, Taxing Cross-Border Services: Current Worldwide Practices and the Need for Change, Online Books IBFD.

A. Skaar, Permanent Establishment: Erosion of a Tax Treaty Principle, Kluwer Law International (1992).

B.J. Arnold Tax Treaty Monitor: Tax Treaty News, Bulletin for International Taxation (2008).

C. Doebbler, Dictionary of Public International Law. Available at

https://books.google.co.za/books?id=751NDwAAQBAJ&pg=PA431&lpg=PA431&dq=omnipotent+authority+international+law&source=bl&ots=PtIW_vDkOs&sig=pgdDfERVqJUuVkfy59Qw2oyws7w&hl=en&sa=X&ved=2ahUKEwjs8tnzkZreAhXRzoUKHb8uDugQ6AEwBnoECAAQAQ#v=onepage&q=sovereignty&f=false. (Accessed 20 November 2018).

CIR v Black 1957 (3) SA 536 (A), 21 SATC 226.

CIR v Lever Bros & Unilever Ltd 1946 AD 441, 14 SATC 1.

Davis Tax Committee Note on Territorial Taxation, 2018. Available at: https://www.taxcom.org.za/docs/20180412%20DTC%20Note%20on%20Territorial%20Taxation.pdf (Accessed February 2019).

Dr. N. Tadmore, Source Taxation of Cross-Border Intellectual Supplies – Concepts, History and Evolution into the Digital Age, Bulletin for International Taxation (2007).

Economic and Financial Commission Report by the Experts on Double Taxation — Document E.F.S.73. F.19 (April 5th, 1923) — Legislative History of United States Tax Conventions. Available at

http://adc.library.usyd.edu.au/view?docId=split/law/xml-main-texts/brulegi-source-bibl-1.xml;chunk.id=item-1;toc.depth=1;toc.id=item-1;database=;collection=;brand=default (Accessed 14 November 2018).

Explanatory Memorandum on the Revenue Laws Amendment Bill, 2000. Available at http://www.treasury.gov.za/legislation/bills/2000/rlam_memo.pdf. (Accessed 12 December 2018).

Explanatory memorandum to the Taxation Laws Amendment Bill 2011. Available at http://www.treasury.gov.za/legislation/bills/2011/Draft%20Explanatory%20Memorandum%20on%20the%20Taxation%20Laws%20Amendment%20Bill%202011.pdf. (Accessed 12 December 2018).

F. Souza de Man, Acknowledgements in Taxation of Services in Treaties between Developed and Developing Countries – A Proposal for New Guidelines (IBFD 2017), Online Books IBFD.

IBFD Glossary.

Income Tax Act No. 58 of 1962, as amended.

Interpretation Note 6 of 3 November 2015. Available at http://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-06%20-%20IN%206%20Resident%20-%20Place%20of%20effective%20management%20(companies).pdf. (Accessed 20 January 2019).

Ishikawajima-Harima Heavy Industries Ltd., ((2007) 288 ITR 408).

J. Hattingh, J. Roeleveld, C. West, Income Tax in South Africa, the First 100 years 1914-2014, Juta Law (2016).

K. Vogel, Chapter 1, The Domestic Law Perspective in Tax Treaties and Domestic Law (G. Maisto ed., IBFD 2006), Online Books IBFD.

Katz Commission, 5th Report – Basing the South African Tax System on the Source or Residence Principle – Options and Recommendations (1997). Available at http://www.treasury.gov.za/publications/other/katz/5.pdf. (Accessed 20 January 2019).

M. Lang, 3. The effects of DTCs in Introduction to the Law of Double Taxation Conventions (Second Revised Edition) (IBFD 2013), Online Books IBFD.

M. McKerchar, Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation, Journal of Tax Research (2008). Available at

http://classic.austlii.edu.au/au/journals/eJlTaxR/2008/1.html. (Accessed 3 October 2018).

OECD Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

OECD Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce, 2015.

OECD Model Tax Convention on Income and Capital (2014).

P. Dittmer, A Global Perspective on Territorial Taxation, 2012. Available at

https://taxfoundation.org/global-perspective-territorial-taxation/#_ftnref9 . (Accessed 15 January 2019).

P. Pistone & Y. Brauner. Introduction in BRICS and the Emergence of International Tax Coordination (Y. Brauner & P. Pistone eds., IBFD 2015), Online Books IBFD.

P.J. Hattingh, South Africa - Corporate Taxation, Country Surveys IBFD. (Accessed 17 January 2019).

Prof. Dr. D. Pinto, The Need to Reconceptualise the Permanent Establishment Threshold, Bulletin for International Fiscal Documentation (2006).

S. Shah, India - Corporate Taxation sec. 7, Country Analyses IBFD. (Accessed 17 December 2018).

SADC website. Available at https://www.sadc.int/about-sadc/ (Accessed 17 December 2018).

Section 9(1)(vii) of India's Income Tax Act. Available at

https://indiankanoon.org/doc/492579/ (Accessed 17 December 2018).

T. Hutchinson, Defining and Describing What We Do: Doctrinal Legal Research, Deakin Law Review, Vol 17, No.1, 2012, pp 83-119. Available at

http://classic.austlii.edu.au/au/journals/LegEdDig/2013/41.html.

UN Model Tax Convention on Income and Capital, 2011.

UN Model Tax Convention on Income and Capital, 2017.

Y. Brauner, OECD - Commentary on Article 5 of the OECD Model, Topical Analyses IBFD.