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THE TAXATION OF ELECTRONIC COMMERCE IN SOUTH AFRICA

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Footnotes

Most of the material used for this Paper was obtained electronically, either from the Internet or from CD-ROM's, therefor page numbers in footnotes may not correspond to prior publication, if any. Internet addresses of material obtained from the Internet are provided in the bibliography.

INDEX

CHAPTER 1 - Introduction

- | | |
|--|---|
| 1.1 The position in the United States of America | 1 |
| 1.2 South Africa and the taxation of electronic commerce | 3 |

CHAPTER 2 - The Nature of Electronic Commerce

- | | |
|-----------------------------------|---|
| 2.1 Going on-line in South Africa | 7 |
|-----------------------------------|---|

CHAPTER 3 - Source and Residence

- | | |
|---|----|
| 3.1 The origins of the source principle | 9 |
| 3.2 Application of the source principle | 9 |
| 3.3 International trends | 10 |
| 3.4 Residence | 12 |
| 3.4.1 The residence of individuals | 12 |
| 3.4.2 The residence of companies | 12 |
| 3.4.3 The residence of a trust | 14 |
| 3.4.4 The residence of a partnership | 15 |
| 3.4.5 Residence in Double Taxation Agreements | 16 |

CHAPTER 4 - Characterising Electronic Income

- | | |
|---|----|
| 4.1 Computer Software Purchased from a Web Site | 18 |
| 4.2 The Purchase of Digital Goods | 20 |
| 4.3 Electronic Services | 21 |
| 4.3.1 Electronic access to databases | 22 |
| 4.3.2 Internet Service Providers | 23 |

CHAPTER 5 - Sourcing the Identified Streams of Income

- | | |
|------------------------------------|----|
| 5.1 Sale of Goods (natural source) | 24 |
| 5.2 Sale of Goods (deemed source) | 25 |

5.3 Royalties (natural source)	26
5.4 Royalties (deemed source)	27
5.4.1 Section 9(1)(b)	27
5.4.2 Section 9(1)(bA)	28
5.4.3 Section 35	30
5.5 Section 9C - Investment income from foreign sources	30
5.5.1 Section 9C	31
5.6 Services	33
5.6.1 Services (natural source)	33
5.6.2 Services (deemed source)	34

CHAPTER 6 - Double Taxation Agreements

6.1 Double Taxation Agreements	37
6.2 Permanent Establishment	38
6.2.1 Business of the enterprise	40
6.2.2 Could a Server Hosting a Web Site be a PE?	41
6.2.3 Business Profits	46
6.2.4 Royalties	47
6.2.4.1 Computer Software	50
6.2.4.2 Know-how	50
6.2.4.3 The Use of Equipment	51
6.2.4.4 Technical Services	52
6.3 Fixed Base (183-day rule)	53

CHAPTER 7 - Conclusion

'...taxes are evil; therefor taxes on the Internet are evil.'

- John S Irons -

'The Internet has become a shoppers paradise... business will never be the same.'

- TIME Magazine, 3 August 1998 -

'If a transaction occurs in cyberspace, where does it occur for tax purposes?'

- USA today, 29 August 1997 -

'The anarchic charm of the Internet presents a bonus for consumers, a more ambiguous set of issues for business, and for the tax authorities, a real headache'

- Neil Russ, Buddle Findlay -

'...this outline will try to lift some of the cosmic fog which seems to settle on the tax community when the Internet is the topic'

- Michael Karlin in a reading before the American Bar Association, May 1996 -

'I surf the Net, therefore I am'

- Graffiti, Long Street, Cape Town -

CHAPTER I - INTRODUCTION

Much has been written on how the Internet affects legal issues, such as defamation and patent infringement, but substantial questions have yet to be answered in regards to how this new trade route will be treated by the various laws of taxation. Taxpayers conducting business electronically realise that they face not only the risk of multiple taxation, but also the serious risk of new or increased taxes.¹ Tax authorities, on the other hand, believe that their tax bases are at risk of erosion because of what they perceive to be new administration and enforcement difficulties.²

During the last two years the world has witnessed a global explosion in electronic commerce,³ involving trade in computer software, entertainment products,⁴ information services⁵ and on-line financial and professional services. The Organisation for Economic Co-operation and Development (hereinafter referred to as 'the OECD') in a discussion document to the Turku Conference on Electronic Commerce (hereinafter referred to as 'the Turku Paper') concluded that the rapid growth of electronic commerce could be attributed, amongst others, to the following:

- start-up capital requirements for businesses to conduct electronic commerce on the Internet are typically low;
- the Internet enables small businesses access to the global market;
- use of the Internet reduces the need for intermediaries in the sale and delivery of goods and services;⁶
- rapid improvements in international communications and technology; and
- advances made with securing electronic payment systems and digital signatures.

1.1 The position in the United States of America (the 'US')

US Treasury Tax Counsel, Joseph H Guttentag, has stated on several occasions that the use of the Internet creates opportunities for tax avoidance as well as for

¹ Dunahoo & Carlisle at 2. France already moved to impose its hefty VAT on international telecommunications 'call-back' services, and the EU is considering the issue. The EU is also considering a 'bit tax' on electronic transmissions of information. See eg IBM's response to the January 1996 report of the EU High Level Expert Group on the Social Aspects of the Information Society available at <http://meritbbs.unimaas.nl/cybertax/ibm.html>

² Ibid

³ The estimate of online shopping revenue in South Africa for 2000 is estimated to be worth R12 billion (Financial Mail, April 10, 1998); The most conservative estimate for world-wide revenues for 2002 is \$41 billion (TIME Magazine, August 3, 1998) and probably the most liberal estimate is world-wide revenues of \$400 billion by 2000 (On the Internet, July/August 1998)

⁴ Eg motion pictures, videos, computer games, digital CD's, chatlines and other online entertainment.

⁵ Eg databases, online libraries, books, magazines and newspapers.

⁶ The Turku Paper at 5.

double taxation. While stressing the importance of not impeding the further development of electronic commerce, he promised that the US Treasury will remain alert to the substantive issues arising from the use of the Internet for commerce, such as sourcing income. He questioned whether it will be necessary to establish 'tax toll booths' along the information superhighway to assure proper administration of the tax law.⁷

The US took the international lead in the search for solutions when the Treasury Department published the '*Selected Tax Policy Implications of Global Electronic Commerce*' (hereinafter referred to as 'the Treasury Paper')⁸ in November 1996. The introduction to this Paper states that:

*'This paper provides an introduction to certain federal income tax policy and administration issues presented by the developments in communications technology and electronic commerce. This paper is a discussion document, designed to elicit views on the issues presented as well as suggestions as to solutions for new problems.'*⁹

The Treasury Paper strongly endorses the need for international agreement on taxing jurisdiction, tax certainty and neutrality.¹⁰ Income from electronic transactions should be taxed in the same manner as income from comparable physical transactions, so that '*decisions regarding the form in which information is distributed are not affected by tax considerations.*'¹¹

The Internet Tax Freedom Act¹², places a moratorium on any new taxes on Internet access and creates a consultative group to study and make recommendations about domestic and foreign policies toward taxation of electronic commerce.¹³ US States and municipalities complain that this Act creates a Cayman Island-like tax-free haven on the Internet and that in treating cyberspace differently from Main Street USA, the principle of neutrality is abandoned.¹⁴ On July 30, 1998 the Senate Commerce Committee unanimously approved the Government Paperwork Elimination Bill (S.2107) generally referred to as the Digital Signature Act. This Bill provides for the use of digital signatures, requires US government agencies to make their forms available on the Internet, allows for the submittal of government forms electronically and allows for electronic payments to the US Treasury.¹⁵ The Internal Revenue Service Restructuring Reform Act of 1998 (H.R. 2676), signed into law on

⁷ Cigler, Burritt & Stinnet at 2

⁸ Full text available at <http://www.fedworld.gov/pub/tel/internetet.txt>

⁹ US Treasury Paper at 1

¹⁰ Dunahoo & Carlisle at 2

¹¹ Treasury Paper at 28

¹² US HR 1054 S 442, full text available at <http://thomas.loc.gov>;

¹³ Tweney at 1; Brush at 1; Irons at 1

¹⁴ Ibid

¹⁵ Hardesty at 1

July 22, 1998, includes provisions requiring the IRS to move to a substantially paperless system by the year 2007.¹⁶

1.2 South Africa and the taxation of electronic commerce.

The first authoritative reference to the taxation of electronic commerce in South Africa is found in the 5th Interim Katz Commission Report, which states that:

*'There is no doubt that these [electronic commerce] developments will greatly impact some of the basic tenets of international taxation as they exist today. Examples include the irrelevance of physical presence in order to trade (impacting on "permanent establishment" concepts), the ease with which current residence notions can be manipulated through hyper-mobility of an entire office or management capacity, and the manner in which goods or services can be contracted for, advertised and even delivered via electronic means'*¹⁷

Although the Commission thought that a pioneering role in formulating rules for electronic commerce taxation would be both dangerous and arrogant, it found that by integrating South Africa's international tax arrangements with international tax conventions and concepts, the South African system should be better placed than most to absorb technical tax changes in this regard.¹⁸

The South African Department of Communications plans to introduce legislation that will cover everything from encryption for secure electronic trading, computer crime and copyright to taxation issues.¹⁹ It seems that the Government is adopting a wait-and-see approach, monitoring attempts to introduce electronic commerce legislation in other countries and consulting with the private sector before publishing a discussions paper that will form the basis of a Green Paper. Director General Andile Ngcaba expressed the opinion that current legislation is insufficient to cope with the boom in on-line trade, particularly when it comes to the borderless nature of the Internet, stating that:

'It is widely accepted that strong encryption [technology] and the ability to move money instantaneously across the planet will undermine the ability of governments to tax their citizens'.²⁰

During 1998 the first South African Internet malls were established, which include 'shops' by well-known banks, computer companies and ticket outlets. Encryption

¹⁶ Ibid; See full discussion of the IRS Restructuring and Reform Act at <http://www.mshb.com/ec/060698.htm>

¹⁷ 5th Katz Commission Report at 7.4.1

¹⁸ Ibid at 7.4.2

¹⁹ McLoed at 44

²⁰ Ibid

technology is provided for vendors and the mall owners generate revenue by renting 'shopfront' space on its websites.²¹ A virtual casino is already operating from Swaziland.²²

This Paper evaluates the consequences that the Internet and electronic commerce present to traditional precepts of taxation, with particular reference to the '*source*' principle in South African tax law and the '*deemed source*' provisions of the Income Tax Act 58 of 1962 (hereinafter referred to as 'the Act'). This will be done by applying these principles and provisions to a number of typical Internet transactions.. As it can also be assumed that much of the tax evolution in this field will take place internationally, Double Taxation Agreements and concepts like '*permanent establishment*' and '*fixed base*' will also be examined against the electronic commerce background.

In this regard it should be noted that the transactions under discussion are of the nature where goods, services and information can be contracted for, paid for and even delivered over the Internet simply by accessing the vendors website on the Internet.

²¹ One of these South African malls, still in the early stages of its development, is available at <http://www.mweb.co.za/tenants.html>; An online mall representing real life Helsinki is available at <http://www.helsinkiarena2000.fi>

²² Available at <http://www.piggspeak.com>

CHAPTER II - THE NATURE OF ELECTRONIC COMMERCE

Although it is beyond the scope of this Paper to present a comprehensive description of the Internet and electronic commerce, it is nevertheless crucial to understand the basics in order to fully appreciate the complex ramifications they present to issues of international and domestic taxation.²³

The Internet refers to the global convergence of previously isolated and disparate computing systems and communications networks into a global "network of networks."²⁴ This convergence has been driven by three major technological changes:

- what started as a US government-financed defence project on a robust packet switching system in the late 1960's turned into the most widely used method of connecting or networking computers;
- telecommunication transmissions has evolved from copper wire to fibre optic cable, with virtually limitless capacity; and
- the ability to convert text, images, audio and video and other content into a common digital format, referred to as digitisation. Any type of information which can be digitised, including cash equivalents, can now be transmitted electronically, easy and on a monumental scale.²⁵

The Internet has no central computer or organisational structure. The global village is truly a village without a chief. Far from being a hub with spokes, it is more like a spiders web. What links the Internet together is the TCP/IP²⁶ protocol, which is simply a means of specifying how data is broken up in packets and assigned addresses to be transferred over the Internet. This allows computers to communicate regardless of differences in hardware and software.²⁷ The fastest growing application of the Internet is the World Wide Web, which is a multimedia, hypertext system which blends text, images, video and audio.

A document on the Web is usually referred to as a web site or web page.²⁸ A uniform addressing system allows users around the world to access information on any of these web pages. The information on web pages is stored in the form of documents or pages on central computers called servers. The location of the server

²³ Muscovitch at 2; For a more in depth study of the Internet see the Treasury Paper at 2.1 - 5.9

²⁴ Treasury paper at 4; see generally <http://nii.nist.gov>

²⁵ Ibid

²⁶ Transmission Control Protocol/Internet Protocol

²⁷ Treasury Paper at 5

²⁸ Servers, Web browsers and search engines communicate by using the Hypertext Transfer Protocol, a special protocol created to transfer hypertext documents over the Web, which accounts for the ubiquitous <http://> prefix in Web addresses.

is irrelevant since it can be accessed by users around the world. For the purposes of this Paper it is important to know that the server computer hosting the web page would in some cases also be owned by the taxpayer, but in most cases the taxpayer will use a server provided by an Internet Service Provider (ISP)²⁹ or other third party to host the web page(s) containing the information. Therefore the owner of the information on the web page is not necessarily the owner of the server.

Electronic commerce could be defined as the ability to perform transactions involving the exchange of goods or services between two or more parties using electronic tools and technology.³⁰

The following two issues pose a particular problem for taxpayers and revenue authorities:

- Security on the Internet.

The Internet is an open and inherently non-secure public system. The solution to this problem involves the encryption of transmissions which is the first line of defence against interception, duplication and alteration. This involves a system of public and private keys. In addition to keeping the contents of a transmission secret, this encryption may also create a digital signature which can enable the recipient of the information to independently verify the identity of the sender.³¹

- Payment systems

New technology has made it possible to pay for goods and services over the Internet. Most of these methods would link existing electronic banking and payment systems (eg credit cards) with new retail interfaces via the Internet.³² These systems should not raise any fundamental tax policy or administrative issues because they essentially represent new ways of executing traditional bank and credit card transactions.

A more recent development in electronic payment systems is the use of electronic cash or e-cash. E-cash is a generic term given to the concept of currency that is digitally signed using the issuing institution's encryption key.³³ This development has the potential for anonymous transfers of money across the globe and revenue authorities will have huge difficulty in ensuring that profits generated over the Internet are declared.

²⁹ Some authors refer to an ISP as an 'Internet Solutions Provider'

³⁰ A collection of Internet links to electronic commerce websites are available at <http://1192.216.71/iw/centre/hotweco.htm>

³¹ Treasury paper at 10

³² US Framework for Global Electronic Commerce at 6.

³³ Muscovitch at 3; in the same sense that a casino chip is a token of value expressed in physical form, e-cash involves value expressed in digital form.

At this early stage in the development of electronic payment systems, the commercial and technological environment is changing rapidly. It would be hard for tax authorities and governments to develop policy that is both timely and appropriate. For these reasons, inflexible and highly prescriptive regulations and rules are inappropriate and potentially harmful. An Economic Communiqué was issued at the Lyon Summit by the G-7 Heads of State calling for a co-operative study of the implications of new, sophisticated retail payment systems.³⁴

2.1 Going on-line in South Africa

The process of commerce enabling a web site is simpler and less expensive than would be imagined in South Africa. There are several complete electronic commerce solutions available from, amongst others, ECnet, BankGate, Virtual Vendor and IBM. ECnet and BankGate use models that allow for immediate authorisation and settlement of transactions by the banks. Security is provided by either the SSL (Secure Sockets Layer) protocol or the SET (Standard Electronic Transfer) protocol. Security is extremely high, with the transaction engine hosted behind a series of firewalls. Payment card details are encrypted when traversing the Internet. The steps to move a business to the Internet in South Africa could be summarised as follows:³⁵

- The first step is to obtain a virtual merchant number from a bank. Not all banks are ready to provide this service but it is likely that most of the larger banks in South Africa will allow virtual credit card purchases by the end of 1998.³⁶
- This virtual merchant number is then supplied to one of the e-commerce enablers like BankGate, ECnet or Virtual Vendor. The e-commerce enabler will issue a serial number and Digital Certificate to the vendor. They also set up an account for the vendor and work with the ISP hosting the vendors web site to configure the web site to accept credit card details.
- The vendor is then e-commerce enabled and a typical Internet transaction will follow the following process:
 1. A client visits the vendor's (taxpayer's) web site and clicks on the item he/she wants to order or purchase;
 2. Thereafter the client is switched to the website of the e-commerce enabler who authenticates the parties and validates the transaction;

³⁴ US Framework for Global Electronic Commerce at 6; A Working Party was formed, with representation from the finance ministries and central banks, tasked to produce a report that identifies common policy objectives amongst countries and to analyse the national approaches to electronic commerce payment systems.

³⁵ Chapman at 18 - 23

³⁶ Ibid at 21

3. The e-commerce enabler sends the fulfilment details to the vendor (taxpayer) who delivers the goods/services to the client; and
4. In the final step the e-commerce enabler instructs the bank to settle the account between the client bank and the vendor bank. The whole process takes a few seconds to complete.

From the abovementioned it is clear that all the technology is available in South Africa to enable taxpayers to conduct business over the Internet. A rapid growth in the already booming trade could therefore be expected.

CHAPTER 3 - SOURCE AND RESIDENCE

3.1 The Origins And History Of The Source Principle.

The first income tax laws in South Africa were based on the source principle, and income tax was only levied on income sourced in the Union (as it then was). This is to a certain extent still the position today.³⁷ Since then several investigations into the advisability of this system have been made. In 1951 the Steyn Committee recommended that the source principle be retained mainly for the reason that changing the system would be too complex and would not have a material impact on revenue.³⁸ In 1970 the Franzsen Commission recommended a change because more income was flowing into the country without being taxed and most of South Africa's trading partners were using a world-wide or residence system.³⁹ Although the Government accepted these recommendations, the changes were never pursued.⁴⁰ In 1987 the Margo Commission made a comprehensive review of the whole issue and came to the conclusion that the disruption that would be caused by a change to a residence system would not justify the possible benefits.⁴¹

The 5th Interim Report of the Katz Commission concluded that, from the perspective of collecting revenue, adopting either a residence or source basis will make little difference as regards active income⁴², but that as regards passive income, a residence system will bring a revenue advantage.⁴³ It was thus recommended that active income should continue to be taxed on a source basis and that passive income should be taxed on a residence basis.⁴⁴

3.2 Application Of The Source Principle

There is no statutory definition of source. The Katz Commission confirmed that it is not in favour of attempting a detailed definition of a phenomenon that can have as many variables as international commerce and investment in the hands of endlessly creative entrepreneurs. Even in the US, with arguably the most detailed legislation

³⁷ The definition of 'gross income' in s 1 of the Act states that an amount is only included in gross income if it is 'from a source within or deemed to be within the Republic'.

³⁸ Steyn Commission Report at para 68 p 19

³⁹ Franzsen Commission Report at para 20

⁴⁰ 5th Katz Commission Report at para 2.1.1

⁴¹ Margo Commission Report at para 26

⁴² See 5th Katz Commission Report at para 3.2.1 where 'active income' is defined as income deriving from direct, operational activity. 'Passive income' is defined as income which is derived from passive forms of investment, such as interest or royalties.

⁴³ 5th Katz Commission Report at para 3.1.1.4

⁴⁴ *Ibid* at 3.2.2

in this regard, the attempt at codification has often run into trouble.⁴⁵ Centlivres CJ in *CIR v Epstein*⁴⁶ said that the Legislature was probably aware of the difficulty in defining source. In *CIR v Lever Brothers & Another*⁴⁷ Watermeyer CJ referred to attempts to define source as an 'impossible task'.

In the *Lever Brothers*⁴⁸ case, Watermeyer CJ held:

'that the source of receipts... 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 that 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 letting its use to someone else. Often the work is some combination of these'

Over the years a wealth of court decisions have been handed down indicating the tests, factors and considerations that should be applied in deciding where the source of income is located.

If the natural source⁴⁹ is found not to be in South Africa, it is necessary to ascertain whether any of the deemed source provisions⁵⁰ apply. If the natural source or deemed source of income is located in South Africa and the income is also taxable in another country⁵¹ the question is resolved with reference to a Double Taxation Agreement, if any, between the two countries in question.

3.3 International Trends

No where in the world is either the source or the residence system applied with any degree of purity. The Katz Commission pointed out that certain international bodies are also favouring a sourced based system.⁵² The Treasury Paper comes to another conclusion, stating that the growth of electronic commerce will require that the principles of residence-based taxation assume even greater international importance. In the world of cyberspace it is often very difficult, if not impossible, to

⁴⁵ 5th Katz Commission Report at 5.1.1

⁴⁶ 1954 (3) SA 689 (A) at 698

⁴⁷ 1946 AD 441 at 454

⁴⁸ 1946 AD 441 at 449-450

⁴⁹ Emslie, Davis & Hutton at 112 use the term 'natural source' and 'actual source' as opposed to deemed source; Huxham & Haupt at 14 refer to 'true source'; these terms are widely used and accepted.

⁵⁰ For the purposes of this paper contained principally in ss 9 & 9C of the Act.

⁵¹ The income could be taxed in more than one country on the basis of residence or where the natural source is in one country and the deemed source in another country; see further Meyerowitz Chapter 30.

⁵² 5th Katz Commission Report at 5.1

apply traditional source concepts to link an item of income with a specific source or geographical location. Therefore, source based taxation could lose its rational and be rendered obsolete by electronic commerce.⁵³ By contrast, all taxpayers are resident somewhere. This argument is echoed by Karlin,⁵⁴ who confirms that the growth of electronic commerce will de-emphasise the significance of the place economic activity is carried on. Mazansky⁵⁵ points out that South Africa is one of the last sophisticated economies of the world where tax is still levied on the basis of source.

In many countries, like in South Africa, provisions were introduced where traditional source concepts were too difficult to apply effectively.⁵⁶ Therefore, as source principles lose their significance, residence-based taxation concepts can step in to take their place. This trend will be accelerated by developments in electronic commerce.⁵⁷

Although the trend seems to be to move to a residence system when, inter alia, electronic commerce is concerned, there is also a danger lurking in the background. At the moment, and presumably for some time in the future, the US has a virtual monopoly on software and other digital exports. Electronic commerce will enable US companies to sell their products electronically from their US head offices. These sales would probably not be attributable to a permanent establishment in another country and a big part of the industry will thus not be exposed to foreign tax. Because of the US monopoly, other states would not have similar advantages. In fact, the result would be a lopsided system that maximises US tax revenues at the expense of other countries.⁵⁸

This result jeopardises the compromise on which the double taxation treaty network is based: the sharing of revenues between countries and eliminating double taxation. Eliminating the source based taxation of income derived from electronic commerce will only improve the US position. Moreover the Treasury Paper's position that no new taxes should be applied on electronic commerce⁵⁹, implies a request to other countries to adopt the same policy. If they do so, the US will have made sure that there is not going to be a substitute for the disappearing source-based taxation.⁶⁰ It is suggested that the South African Government keep this in mind during treaty negotiations or as it seeks new and expand old principles to deal with electronic commerce.

⁵³ Treasury Paper at 7.1.5

⁵⁴ Karlin at 5

⁵⁵ Mazansky at 1.

⁵⁶ In s 863(e) of the US Tax Reform Act of 1986 such rules were adopted for certain space and ocean activities.

⁵⁷ Treasury Paper at 7.1.5

⁵⁸ Pinkernell at 2

⁵⁹ Treasury Paper at para 7.1.1 & 7.3.1

⁶⁰ Ibid at 2

3.4 Residence

As a result of the deemed source provisions (found mainly in s 9 of the Act) income which is in reality sourced outside South Africa, is deemed to be from a South African source. In the case of a natural person the test is '*residence*' or '*ordinarily resident*' in South Africa and in the case of a non-natural person the test is whether such an entity is '*managed and controlled*' in South Africa. To understand the effect that these deemed source provisions have on electronic commerce, it is necessary to examine the meaning of the residence principle in South African tax law against the Internet background.

3.4.1 The residence of individuals.

The criteria to establish the residence of natural persons in a fiscal context, is the term '*ordinarily resident*'.

The concept of '*ordinarily resident*' is well understood in our law,⁶¹ although it is not defined in the Act. In *CIR v Kuttel*⁶² it was held that the concept has a narrower meaning than the term '*resident*'⁶³ and Goldstone JA referred to a English case⁶⁴ where it was held that the natural meaning of '*ordinarily resident*' was:

'[that] the person must be habitually and normally resident here, apart from the temporary or occasional absence of long or short duration.'

The Court also referred to the South African case of *Cohen v CIR*⁶⁵ which held that '*ordinarily resident*' would be:

'the country to which he naturally and as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principle residence and it would be described more aptly than other countries as his real home'.

In the context of electronic commerce the residence of natural persons create no new problems.

3.4.2 The residence of companies.

A '*domestic company*' is defined in the Act as:

*'a South African company or a company which is managed and controlled in South Africa'.*⁶⁶

⁶¹ 5th Katz Commission Report at 6.1.1.1 where the Commission recommended that this concept should be retained.

⁶² 1992 (3) SA 242 (A)

⁶³ Ibid; see also Huxham & Haupt at 16.1.5.

⁶⁴ R v Barnet London Borough Council: Ex parte Shah & Other Appeals [1982] 1 All ER 698 (CA) at 248.

⁶⁵ 1946 AD 174 at 185.

Meyerowitz⁶⁷ is of the opinion that a company is '*managed and controlled*' in South Africa when the directors meet in South Africa to transact the company's business, and not because the majority of the shareholders reside in South Africa. Huxham and Haupt⁶⁸ also consider a company to be '*managed and controlled*' in South Africa if that is where the directors have their meetings.

The main criticism of the definition of a '*domestic company*' is that it has proven subject to relatively simple, formalistic manipulation. The concept is also out of line with the internationally used and much more substantial tax treaty expression of '*effective management*'.⁶⁹ It should be pointed out that major strides in global telecommunications technology make it possible for directors to meet in cyberspace by using videoconferencing technologies or to manage and control a company from outside its country of operation.⁷⁰ Videoconferencing is expected to become more widespread with the introduction of inexpensive desktop video cameras that can be connected to a personal computer, coupled with higher speed Internet connections.⁷¹

The Katz Commission recommended that the concept of '*effective management*' as referred to in article 4(3) of the OECD Model Tax Convention should be used to designate the tax residence of companies.⁷² The Commentary to this Model Convention (hereinafter referred to as the 'OECD Commentary') states that the place of effective management is the place where the company is actually managed⁷³ and the South African Revenue authorities seem to define the place of '*effective management*' as the place where the day to day running of the business takes place.⁷⁴

In the context of electronic commerce a company may for all practical purposes only exist in cyberspace; conducting its business electronically and directors meeting by videoconferencing over the Internet. It is suggested that the residence of such a company should be the location of the server that hosts the home website of the company, as that would be the place where the day to day running of the company takes place. However, this suggestion would be far removed from the management of the company, which seems to indicate human activity. Another argument would then be to look at the place where the directors meet, but if they meet via videoconferencing it would indeed be very difficult to attribute such a meeting to a specific geographic location. For the time being, and in the absence of clearer guidelines, the location of the server hosting such an '*electronic company*' or the

⁶⁶ Sec 1 of the Act, a South African company is also defined in s 1; a company is managed and controlled in the Republic, when as a matter of fact, the management and control of the company is exercised in the Republic, see further Meyerowitz at 24.2

⁶⁷ At 24.2 fn 2.

⁶⁸ At 14.1.3

⁶⁹ 5th Katz Commission Report at 6.1.2.1

⁷⁰ Mazansky at 5.

⁷¹ The Treasury Paper at 3.2.8

⁷² Ibid.

⁷³ OECD Commentary a 4 para 3 at 22.

⁷⁴ Van Blerck and Horak at 9.

country of incorporation seems to be the only criteria than can be successfully applied.

The abovementioned example, would furthermore be problematic where the server is located in one state and the company is incorporated in another state. In such a situation the tie-break provisions contained in Double Taxation Agreements should be applied and the United States and Canada have indicated that they consider the place of incorporation the final and only test.⁷⁵

The Treasury Paper states that a review of current residency definitions might be appropriate, but does not elaborate thereon.⁷⁶ It is suggested that Machiel Lambooi⁷⁷ came to the correct conclusion:

'I believe that fine-tuning of the traditional residence rules to the new cyberspace environment will have to be considered. Corporate residence in cyberspace needs rethinking. Tax policy should try not to fall too far behind technological advances.'

3.4.3 Residence of a trust.

In s 1 of the Act a 'person' is defined to include a trust. Therefore, the Act considers a trust a person for tax purposes. Where the Act refers to the ordinary residence of 'a person (other than a company)⁷⁸ it also includes a trust.

In *Nathan's Estate v CIR*⁷⁹ the Court held a trust to be resident in Natal because the trustees were resident in that province and it was from that province that the fund was administered. Meyerowitz⁸⁰ states that a trust as a persona for tax purposes is akin to a company whose residence is where the central management and control abodes. Mazansky⁸¹ is of the opinion that the term '*ordinarily resident*', despite the approach by the courts in the past, is only appropriate to natural persons and not to other non-company persons. In the United Kingdom the residence of the trustees is examined to establish the residence of a trust, and the corporate test of management and control does not apply.⁸² Emslie, Davis & Hutton⁸³ state that:

'The test adopted in Nathan's Estate, namely to look at the place of residence of the trustees and the place from which the trust was

⁷⁵ OECD Commentary at 'Reservations to Article 4'.

⁷⁶ Dunahoo & Carlisle at 4

⁷⁷ Lambooi at 7; Some of the domestic criteria used to establish the residence of companies in other jurisdictions, include, amongst others: place of registered office; place of day-to-day management; centre where superior management is located; place where board meetings are held; location of head office; place of the company's directors domicile; place where the general meetings of shareholders are held; and place where the company's administration are kept.

⁷⁸ Eg in s 9(1)(b)(ii).

⁷⁹ 1948 (3) SA 866 (N).

⁸⁰ Meyerowitz at 16.137 at fn 2.

⁸¹ Mazansky at 7.

⁸² Ibid.

⁸³ At 964.

administered, is similar to the approach... that a trust is ordinarily resident (similar to a company) in the country where its central management and control abide. Central management and control are likely to abide where the trustees reside, or where the majority of them reside, but this need not necessarily be the case.'

It should be noted that the question as to the residence of a trust, creates no problem in s 9C and 9D of the Act, where residence is established by reference to 'natural person' and 'any person other than a natural person'.⁸⁴ In these sections, the residence of a trust, being a person other than a natural person, would be the same as that of a company and electronic commerce would present the same problems as those mentioned above.

3.4.4 Residence of a partnership.

As the Internet reduce the use of intermediaries and employees and require low start up capital, partnerships could be considered an ideal vehicle to access the global market.

In South Africa a partnership is not a legal person distinct from the partners,⁸⁵ nor is a partnership a taxable *persona* for the purposes of the Act. Partners share the actual income of the partnership according to the partnership agreement. According to Centlivres CJ in *CIR v Epstein*,⁸⁶ where a partner carries on his activities for the partnership in South Africa, his income from the partnership is derived from a source in South Africa, notwithstanding the fact that the other partner resides and renders services to the partnership outside South Africa. The activities or services rendered by the partner to the partnership is the originating cause of the partner's share, and will be sourced where these services or activities take place.

If a partnership conducts electronic business, and a partner either maintains or updates a website, his or her share of the profits will be sourced to the place where such work or services were done. As website maintenance and updating could be done electronically from a remote computer situated anywhere on the globe, the current position opens the door for tax avoidance and creative tax planning. Emslie, Davis & Hutton⁸⁷ are of the opinion that Centlivres CJ solely examined the activities of one partner in relation to his share of the income and that the minority judgement of Schreiner JA is preferable to that of the majority. In the minority judgement Schreiner JA⁸⁸ stated that:

'since a business may be carried on through partners or other agents the place where the taxpayer's income originate is not where he personally

⁸⁴ Sec 9C(1).

⁸⁵ See *R v Levy* 1929 AD 312.

⁸⁶ 1954 (3) SA 689 (A).

⁸⁷ At 137

⁸⁸ 1954 (3) SA 689 (A) at 700

exerts himself, assuming that he does so, but where the business profits are realised.'

However, this case deals with the source of a partners share of the income and not with the question of residence of the partnership.

The OECD Commentary states that:

*'The Convention does not... contain any special provisions relating to partnerships. Contracting States are however left free to examine the problems of partnerships in their bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate.'*⁸⁹

In the tax treaty between South Africa and the United States, a 'person' is defined to include a partnership and can therefore be a 'resident' of either the United States or South Africa.⁹⁰ This would not be a foreign concept to South African tax law. In *Nathan's Estate v CIR*⁹¹ De Wet J stated that:

'Now if it could be said that an artificial person cannot have a residence, then it would be a strong argument in favour of the contention that 'person' was used in a narrower meaning, but it is quite clear that an artificial person can have a residence... It is true that the cases I have referred to dealt with companies, but there is no reason why other artificial persons should not have a residence as well'

It is therefore suggested that the residence of a partnership should be established in the same way as that of a trust and obviously the same problems would occur.

3.4.5 Residence in Double Taxation Agreements

In most of the Double Taxation Agreements South Africa entered into after 1994⁹² the residence of a individual is established by the well known principle of '*ordinarily resident*' and that of non-individuals at the '*place of effective management*'. Of these recent treaties only the treaties with Hungary and Romania refer to the residence of non-individuals in terms of the older concept of '*place of management or control*'.

Some of the older agreements⁹³ establish residence by referring to '*any person who under the laws of South Africa is liable for taxation be reason of domicile, residence, place of management or any criteria of a similar nature.*'

⁸⁹ OECD Commentary a 1 para 6.

⁹⁰ At a 3(c); See the Commentary to the Treaty under Article 4 (Residence).

⁹¹ 1948 (3) SA 886 (N)

⁹² Austria, Canada, the Czech Republic, Denmark, Finland, France, Hungary, India, Ireland, Japan, Korea, Lesotho, Malta, Norway, Poland, Romania, Singapore, Taiwan and the United States all in a 4(1)(b) of the respective treaties and Thailand and Sweden in a 4(1)(a).

⁹³ Botswana in a 3, Israel in a 3(1), Swaziland in a 4(1), Switzerland in a 4(1), the Netherlands in a 4(1) and the United Kingdom in a 3(1).

The treaties with Malawi⁹⁴ and Namibia⁹⁵ refers to both individuals and non-individuals in the context of '*ordinarily resident*'. These two treaties are the only treaties where the residence of a company is established by the '*ordinarily resident*' concept. It is suggested that the Courts should apply the modern concept of '*place of effective management*' to decide whether a company is resident in South Africa, Malawi or Namibia.

The few remaining treaties refer to the '*ordinarily residence*' of persons other than companies and the '*place of incorporation, management or control*' in the case of companies.⁹⁶

None of the concepts used in these Double Taxation Agreements provide any answers to the problems that electronic commerce create in the context of residence.

⁹⁴ Art 2(1)(g)(i).

⁹⁵ Art 2(1)(g).

⁹⁶ Germany in a 3(g)(aa) and Uganda and Tanzania in a 2(f).

CHAPTER 4 - CHARACTERISING ELECTRONIC INCOME

Not only is the Internet changing traditional ways of doing business, it is also generating new businesses and ways of doing business. This result in new electronic products, delivery systems and even electronic companies operating in cyberspace. It is no longer easy to determine whether a taxpayer is selling goods, the use of intangibles or services.⁹⁷ The principle of neutrality requires that the tax system treat economically similar income equally, regardless of whether earned electronically or whether the product was delivered digitally.⁹⁸ Before transactions can be sourced, it is necessary to identify the type of transaction and the income that arises, as different types of income are sourced differently in South African tax law and in Double Taxation Agreements. In this chapter electronic income will be characterised by evaluating some of the most common Internet transactions.

4.1 Computer Software Purchased From a Web Site.

In many countries the courts and the revenue authorities are struggling with the commercial treatment of software.⁹⁹ As software sales are made pursuant to licensing agreements, it is uncertain whether the sale give rise to royalty income or more closely resembles a sale.

The Copyright Amendment Act¹⁰⁰ brought the Copyright Act 98 of 1978 into the computer age. Computer programs are now protected as a separate, *sui generis* category of protected works. A computer program is defined in s 1 of the Copyright Act¹⁰¹ as:

'a set of instructions fixed or stored in any manner and which, when used directly or indirectly in a computer, directs its operation to bring about a result.'

Computer software is also defined in the 1992 OECD Commentary¹⁰² which will be discussed under the treatment of software in the context of Double Taxation Agreements. This Commentary, however, can be useful in applying and developing

⁹⁷ Cigler, Burritt & Stinnet at 2

⁹⁸ Margo Commission Report Chap 4 Part III; Treasury paper at 6.2 & 7.3

⁹⁹ Ibid at 5; the Treasury is currently considering proposed regulations on the classification of income from transactions involving computer programs, see US Prop. Treas. Reg. s 1.861 - 18, 61 Fed. Reg. 58, 152 (13 November 1996)

¹⁰⁰ 125 of 1992

¹⁰¹ 98 of 1978

¹⁰² OECD Commentary at para 12

domestic law. The Copyright Act¹⁰³ further introduces specific rules in respect to the nature of copyright in a computer program.¹⁰⁴

The crisp issue is whether the payment for the right to use the software constitutes income received or accrued for the use of the copyright.¹⁰⁵ Sher¹⁰⁶ comes to the conclusion that the right to use computer software is inextricably linked to a license of the copyright. De Hosson,¹⁰⁷ however, comes to a contrary view by applying the 1992 OECD definition.

Section 11B of the Copyright Act¹⁰⁸ reserves certain acts exclusively for the owner of a copyright in software¹⁰⁹ and the fact that the legislator did not include the mere use of the software could be interpreted to mean that the granting to use the software would not constitute use of the copyright.¹¹⁰ The Copyright Act, thus distinguishes the user of software from a person who has the right to copy (reproduce) the software for use other than private use. It is therefore suggested that the payments made by a South African purchaser for the electronic delivery of a computer program do not constitute royalties. In every case the contract underlying the sale and the particular circumstances and facts should be examined to establish whether the payment was for a sale of goods or royalties.¹¹¹

The International Fiscal Association (hereinafter referred to as the IFA) passed a number of final resolutions during its annual congress in New Delhi in October 1997 on the issue of software transfers. The principles underlying these resolutions provide valuable guidance to the questions posed by the electronic transfer of software. The resolutions are as follows:

- In determining the classification of income from software transfers, the most important distinction is that between the sale of a software product and the granting of rights with respect to the underlying copyright.¹¹²
- The transfer of standard software for the internal use of the transferee should be treated as the sale of a product, even though certain sales reflect the customary

¹⁰³ 98 of 1978

¹⁰⁴ Sec 11B & s 19B; before the amendment the courts treated computer programs as 'literary works'; Northern Office Micro Computers Pty(Ltd) and Others v Rosenstein 1981 (4) SA 123 C

¹⁰⁵ Horak at 2

¹⁰⁶ As quoted by Horak at 2; See Sher, *SA Income Tax Implications for the foreign Exporter of Computer Software and Technical Service to South Africa*, Technical Report, BCom Hons UCT, 1992

¹⁰⁷ As quoted by Horak at 2

¹⁰⁸ 98 of 1978.

¹⁰⁹ These acts are mainly to: (i) reproduce the program; (ii) publish the program; (iii) make an adaptation; (iv) reproduce the adaptation; and (v) let a copy of the program.

¹¹⁰ Horak at 3; Only when the owner grants the user (purchaser) the right to do any of the acts listed in s 11B, would such person be entitled to use the copyright. This view is reinforced by the provisions of s 19B of the Copyright Act 98 of 1978.

¹¹¹ Only when the owner grants to the purchaser the right to perform the acts listed in s 11B of the Copyright Act 98 of 1978, would such person be entitled to use the copyright in the software.

¹¹² IFA 51st Congress Sub I Res IV A; No reference is made to the manner in which the software is physically transferred, because it is believed that the manner in which the software is transferred (whether for example by disk, CD-ROM, Internet etc) should not be a factor; See notes to Sub I at 4.

protection of the copyright owner. The same characterisation should apply to site licenses.¹¹³

- Income from the grant of an exclusive right to use software in a specific jurisdiction and for the useful life of the product should be treated for tax purposes as a sale of copyright.¹¹⁴
- A reproduction license (unless it is a site license) may constitute a license (royalty) unless it involves the disposition of an entire right such as an exclusive geographical license for the useful life of the product.¹¹⁵

It is therefore suggested that South African copyright law, the OECD and the IFA, treat consideration for the use of computer software as consideration for the sale of goods and not as royalties. On October 2, 1998 the IRS in the United States declared that software purchased over the Internet will be treated exactly the same as software purchased and delivered on a disc.¹¹⁶

4.2 The Purchase Of Digital Goods Other Than Computer Software

As pointed out above, any product that can be digitised can be sold and delivered electronically. This would include, books, newspapers, CD's, motion pictures, photographs, airline and movie tickets, videos and sound recordings. Patents, designs and trade marks that can be digitally converted can also form the object of electronic commerce, whether in the form of an out-and-out sale or in the form of some limited transfer of rights.

Musical works, literary works and other works that can be copyright protected used to be easily distinguishable for purposes of the Copyright Act¹¹⁷ by the medium by which they were communicated (eg gramophone record, book etc.). Nowadays all these can be communicated and purchased in digital form. This was partially addressed by the legislator in the Copyright Amendment Act¹¹⁸ by the fact that the authorship in these works are now grouped together if they are 'computer-generated'¹¹⁹ The Copyright Act¹²⁰ does not offer protection for digitised audio and

¹¹³ Ibid Sub I Res IV B; A 'site license' means a license that allows the user to make a certain number of copies of the program solely for internal use by persons in the organisation of the user; See notes to Sub I at para 4

¹¹⁴ Ibid Sub I Res IV C.

¹¹⁵ Ibid Sub I Res IV D.

¹¹⁶ US Treas. Reg. 1.861-18 effective from October 2, 1998.

¹¹⁷ 98 of 1978

¹¹⁸ 125 of 1992

¹¹⁹ Sec 1(1) sv 'author' (h); According to Van der Merwe the term 'computer-generated' is subject to different interpretations. One construction is that the computer actually combined the elements of the work itself, using some form of artificial intelligence. Another is that the work has been created by humans and the computer is simply used as storage or presentation device. In the latter event, 'computer-generated' means nothing more than digitised.

¹²⁰ 98 of 1978

video and for computer-held databases¹²¹ and therefore consideration for these could never be classified as royalties.

Digitised goods furthermore presents unique issues because it can be perfectly reproduced by the purchaser. A purchaser who desired to purchase ten copies of a book will generally purchase ten copies from the publisher, but someone wishing to purchase ten copies of a electronic book may simply purchase one copy and acquire the right to make nine additional copies. Thus, the question whether the consideration is royalties or for a sale, remains. The courts might consider that the transaction creates royalty income, since the right to make reproductions is a right reserved by the copyright holder and by allowing a third party to make reproductions, the payment is (at least in part) consideration for the use of the copyright. On the other hand this transaction may be viewed as merely a substitute for the purchase of ten copies from the publisher.¹²²

It is therefore suggested that the courts and revenue authorities will have to examine the underlying contract to the sale, the facts and circumstances of the case and apply the definitions of patent, design, trade mark and royalties in the Act¹²³ in a manner that takes into account the unique characteristics of digitised information. The same argument applies to the interpretation of Double Taxation Agreements.

The European Commission (the policy making body of the European Union) announced on June 17, 1998 that the sale of digital products will be taxed as services in the European Community.¹²⁴ This view conflicts with that of the OECD and the United States Internal Revenue Service which concludes that in the classification between goods or services, the means of delivery is irrelevant. It is furthermore suggested that the view of the EU does not adhere to the principle of neutrality.

4.3 Electronic Services.

Digitised information further complicates existing difficulties in defining services income, as distinguished from the sale of goods and royalties. This distinction is important for the application of both domestic tax law and Double Taxation Agreements.

Currently a vast array of services are available on the Internet, from daily horoscopes and adult entertainment to professional services by accountants and advocates, banking services and communication services like videoconferencing and 'chat-lines'. Most of these services are clearly services for tax purposes, but in

¹²¹ Van der Merwe at para 7

¹²² Ibid at 7.3.2

¹²³ See eg ss 9(1)b & 9C.

¹²⁴ Hardesty *European Commission says Electronically Delivered Products are Services* at 2

some cases these 'services' are of such a nature that it is unclear whether they should be regarded as services, the sale of goods or even producing rental income for tax purposes.

4.3.1 Electronic access to databases

Several web sites offer direct on-line access to proprietary databases. These include credit reporting agencies, legal and tax databases, on-line libraries and encyclopaedias.¹²⁵ These web sites allow a person access to their databases and payment is based on a variety of factors such as time spent accessing the central computer, the number of searches made, etc. In addition, several publishing businesses are migrating their products to the Internet. For example, the Wall Street Journal offers an on-line subscription that provides a number of benefits including real-time breaking news reporting and the ability to customise the type of articles that will be automatically '*clipped*' for each user. On-line magazines offer even more services such as bulletin boards and searches.

The correct classification of electronic access to databases are even less clear than that of software or other on-line services. The sale of a newspaper or magazine would generally be considered the sale of goods. On the Internet, however, users can search old newspapers and magazines for information, or customise the newspapers and magazines they buy to suit their particular requirements. Would this change the sale of the newspaper and magazine from a sale of goods to services? Alternatively, could the consideration be for the sale of an 'information' product, or even royalties?

The use of CD-ROM's¹²⁶ is even more problematic. Previously a reference work, such as an encyclopaedia, would have been sold as a set of bound volumes and would have resulted in a sale of goods for tax purposes. Now, instead of purchasing a bound volume, a potential customer might be able to choose between a CD-ROM containing the information or the on-line service on the Internet, through which the encyclopaedia's content could be accessed. The sale of the CD-ROM would generally be regarded as a sale of goods, while the character of the income arising from the on-line service is not clear.

Both the OECD¹²⁷ and authors like Cigler, Burritt & Stinnet¹²⁸ come to the conclusion that it will be necessary to reconsider existing principles in this area and that the various tax authorities will develop different interpretations on a given set of facts. This would result in a situation where a transaction is considered a sale on one jurisdiction and a service in another. It is therefore suggested that international

¹²⁵ The Turku paper at 27; Cigler, Burritt & Stinnet at 8.

¹²⁶ A CD-ROM could be defined as a compact disc with a database of either software, text, video, audio, or a combination thereof, with a high storage capacity accessible through a personal computer.

¹²⁷ The Turku Paper at 27.

¹²⁸ At 26.

consensus on these issues are paramount and that characterisation policy should not be formulated at a domestic level.

It is suggested, however, that payments for access to these databases should be characterised as payments for services.

4.3.2 Internet Service Providers (ISPs)

ISPs play a very important role in electronic commerce, as they allow businesses to move their goods and services to the Internet and provide purchasers access to these goods and services. ISPs have sprung up basically overnight in cities and towns across South Africa. Amongst the services they provide are connections to the Internet for both businesses and purchasers (referred to as dial-up access), advertising, reminders, submission of URLs to various search and directory sites across the world, web page design, web site hosting, corporate or lease line access and domain name registration.¹²⁹

Although some of these services cannot be conducted electronically (yet), they play an important role in electronic commerce as websites of businesses are in most cases hosted on the servers of these service providers. In addition, ISPs provide the ability to consummate an entire electronic business transaction, including customer sign-up and billing. Cigler, Burritt & Stinnet¹³⁰ examine the possibility that some of the services provided by ISPs could not be regarded as services but something else. For example payments for placing information (like a website) on a host server could be regarded as rental income, from the lease of tangible personal property. However, they come to the conclusion that for tax purposes, all the services provided by service providers should be regarded as services.

¹²⁹ A comprehensive list of services with prices are available on the websites of these service providers, eg M Web at www.mweb.co.za/services.html and Spinner Internet Services at www.spinner.co.za/services.htm.

¹³⁰ At 15

CHAPTER 5 - SOURCING THE IDENTIFIED STREAMS OF INCOME

In this chapter the different types of income characterised in the previous chapter will be sourced by application of the source principle and the deemed source provisions of the Act.

5.1 Sale of goods - natural source

In the case of income received or accrued as a result of the sale of goods there is a specific deeming provision in the Act.¹³¹ For this reason it is still unclear whether the source of a sale of goods is the conclusion of the contract, performance by the seller, payment by the purchase or a combination thereof. It would appear that payment by the buyer does not matter and that the originating cause must be sought in a combination of the conclusion of the contract and performance by the seller.¹³²

Meyerowitz¹³³ states that:

'(t)he location of the originating cause, particularly the conclusion of the contract, should not be tested by technical rules of law... but by the activities and services of the seller which will usually be where his business is being carried on'.

Maisels JA held in *Transvaal Associated Hide & Skin Merchants v COT Botswana*¹³⁴ that when the activities of a person are performed in two or more countries, the locality of the source must be determined by reference to those of the activities which constitute the dominant, main or real and basic cause of the accrual of the income.

It is suggested that the originating cause of the electronic sale of goods, could be the activity of making that digital goods available on a website. Of several possible originating causes,¹³⁵ the activity of making the digital goods available on a website would be the only *'work which the taxpayer does'*.¹³⁶ All the other activities are usually done automatically and electronically by the server computer without the presence or even knowledge of the taxpayer. The stock in trade will usually only be one copy of the digital article, automatically copied and delivered by the server in the case of a sale. It is suggested that the source of an electronic sale of goods

¹³¹ Sec 9(1)a of the Act.

¹³² *Ibid* at 7.34; *CIR v Lever Bros and Another* 1946 AD 441; *CIR v Epstein* 1954 (3) SA 689 (A).

¹³³ *Ibid*.

¹³⁴ 29 SATC 97 at 111; in this case the taxpayer was buying and selling hides. The hides were bought in Botswana and sold in South Africa. The court held that the processing and not the sales of the hides was the real source of the profit.

¹³⁵ Eg the electronic conclusion of the contract by the seller's server computer, the access of the website by the purchaser and the electronic payment by the purchaser.

¹³⁶ See *CIR v Lever Brothers & Another* 1946 AD 441 at 449-450 as quoted above.

would probably then be the physical location of the server computer hosting the web site. Therefore the natural source of the electronic sale of goods would only apply to taxpayers who has their web sites hosted on a server in South Africa.

5.2 Sale of goods - deemed source.

Amounts accrued to or received by a person¹³⁷ by virtue of a contract made in South Africa for the sale of goods are in terms of s 9(1)(a) of the Act deemed to be from a source within South Africa, whether such goods have been delivered or are to be delivered in or out of South Africa. This provision applies even though the seller has no connection with, and does nothing more than conclude the contract of sale in South Africa.¹³⁸

This provision has been criticised by the Margo Commission and the Katz Commission, but the legislature has not yet reacted to the criticism.¹³⁹ The Katz Commission is of the opinion that the provision is an example of lack of clarity and futility. It is easily and formalistically circumvented.¹⁴⁰ Meyerowitz¹⁴¹ also questions the wisdom of this provision, stating that it depends upon legal subtleties as to the place of conclusion and that in any event, it can be easily circumvented.

For this provision to apply the sale must relate to 'goods'. Although Meyerowitz¹⁴² consider that this provision is confined only to corporeal movables, it is suggested that the principle of neutrality implies that digitisation of goods should not render the provision inapplicable.

A binding contract is constituted by acceptance of an offer. The acceptance must reach the seller and at that time the contract is completed. In cases dealing with telephone contracts it was held that the contract is concluded at the place where the acceptance is conveyed to the seller, i.e. the place where the seller is.¹⁴³ It is suggested that the same rules would apply to an electronic contract. An electronic contract concluded on the Internet would thus be concluded at the location of the server hosting the website of the seller. The widespread use of automated bank teller machines and parking garages seems to indicate that a computer could be a party to a contract and accept offers, or at least be regarded as an electronic agent.

Electronic offer and acceptance raises a number of questions. Is downloading a manner of acceptance? Does clicking on a 'YES' or 'BUY' icon constitute

¹³⁷ Person include an natural person, company, closed corporation, club, insolvent estate, deceased estate, trust etc.; See Meyerowitz at 5.1 and Huxham & Haupt at 1.1

¹³⁸ Sec 9(1)a of the Act; Meyerowitz at 7.35.

¹³⁹ 5th Katz Commission Report at 5.2(ii)

¹⁴⁰ Ibid.

¹⁴¹ At 7.39; Other more appropriate connecting factors could have been chosen eg that the taxpayer is carrying on the business of selling in South Africa. Such an approach would have brought much of the revenues created by the electronic sale of goods into the South African tax net.

¹⁴² At 7.37

¹⁴³ *Tel Peda Investigation Bureau (Pty)Ltd v Van Zyl* 1965 (4) SA 475 (E); *S v Henckert* 1981 (3) SA 445 (A) at 451; This is referred to as the information theory, see further Meyerowitz at 7.38 and Joubert, Otto & Grove at 36 - 37.

acceptance? Will information on a seller's website constitute an offer, as opposed to a mere invitation to bargain? Can a computer server make and accept offers?¹⁴⁴ These questions relate to the impact electronic commerce is having on the South African law of contract and is beyond the scope of this paper.¹⁴⁵ Advances made with security and encryption technology allow parties to a contract to authenticate their respective identities and to 'sign' contracts digitally.¹⁴⁶

It is therefore suggested that s 9(1)(a) of the Act would only apply to electronic contracts of sale where the seller's web site is hosted on a server located in South Africa. Therefore, the world-wide income of any person selling goods from a website located in South Africa would be sourced in South Africa, that being the place where the contract was concluded. The possibility to collect these taxes would be very remote, for example where a Canadian resident buys a digital book from a company incorporated in Australia through a web site hosted on a server in South Africa and pays the purchase price electronically to the Australian company.

5.3 Royalties - natural source

Information that can be digitised is generally protected by copyright law.¹⁴⁷ The question of the source of royalties came up for consideration in *Millin v CIR*.¹⁴⁸ The Court regarded royalties as sourced in South Africa if the intellectual property was developed in South Africa, irrespective of where the asset is used to generate the royalties.¹⁴⁹ In the case of *Smith v Secretary of Inland Revenue*¹⁵⁰ the Appellate Division cast doubt on the reasoning of the court in *Millin's* case in refusing to equate copyright to property, by stating that the court's finding that copyright is not a capital asset was not necessary for its decision, but the general principle in *Millin's* case still applies

Thus, royalty income generated by a South African resident is largely taxed on a residence basis under the current tax law and royalties earned by a non-resident would not be sourced in South Africa.¹⁵¹ The borderless nature of the Internet allows South African residents to move their intellectual property with minimal difficulty to a computer server anywhere in the world to generate income outside South Africa. On the basis of *Millin's* case a court may well hold that the income received by the South African resident in respect of the use of the immaterial property owned by it abroad is of a South African source because such income is derived from '*the exercise of owner's wits and labour in South Africa*'.¹⁵² However, it might be argued

¹⁴⁴ See Greguras 3 - 7 for a detailed analysis of US on-line contract law available at http://www.oikoumene.com/ec_contracts.html

¹⁴⁵ See Joubert, Otto & Grove at 24 - 58 for the general principles.

¹⁴⁶ The Treasury Paper at 4.2

¹⁴⁷ *Ibid* at 7.32

¹⁴⁸ 1928 AD 207 at 216.

¹⁴⁹ *Ibid*; 5th Katz Commission Report at 6.3.1.1.

¹⁵⁰ 1968 (2) 480 (A) at 488 - 489

¹⁵¹ 5th Katz Commission Report at 6.3.1.1 & 6.3.2.1.

¹⁵² 1928 AD 207 at 216

(in the light of *Smith's case*¹⁵³), that the intellectual property is a capital asset and that the royalty income arose from the employment of such capital asset abroad, and are accordingly of a non-South African source.¹⁵⁴ If that is the case and the royalty income is remitted back to South Africa, s 9C would most likely apply.

5.4 Royalties - deemed source.

5.4.1 Sec 9(1)(b)

Section 9(1)(b) of the Act deems an amount to have accrued to any person from a South African source if it has been received by or accrued to him/her by virtue of the use or the right to use in South Africa or the grant of permission to use in South Africa -

- (i) *any patent as defined in the Patents Act 57 of 1978, or any design as defined in the Designs Act 57 of 1967, or any trade mark as defined in the Trade Marks Act 194 of 1993, or any copyright as defined in the Copyright Act 98 of 1978 or any model, pattern, plan, formula or process or any other property or right of a similar nature; or*
- (ii) *any motion picture film, or any film or video tape or disc for use in connection with television, or any sound recording or advertising matter used or intended to be used in connection with such motion picture film, film or video tape or disc.*¹⁵⁵

This provision does not apply to income received by a natural person not ordinarily resident in South Africa, Namibia, Botswana, Lesotho and Swaziland or to an external company¹⁵⁶ in respect of the use in any printed publication of such copyright, otherwise than for advertising purposes in a motion picture film or television.¹⁵⁷ It is suggested that any printed publication that is subsequently also available digitally, i.e. books and magazines, should also qualify for the exclusion. The justification of this exclusion could be questioned in a tax system that seeks neutrality.¹⁵⁸

Furthermore, this provision also excludes consideration for the outright disposal of the things enumerated, as the provision only refers to the '*use or right of use... or the grant of permission to use*'. Where any of the things enumerated is assigned outright the consideration therefore, whether it takes the form of a lump-sum

¹⁵³ 1968 (2) 480 (A) at 488 - 489

¹⁵⁴ COT v William Dunn & Co Ltd 1918 AD 607; Cleaver & Hutton at 3.3

¹⁵⁵ Sec 9(1)(b).

¹⁵⁶ An external company is a company other than a domestic company, see definition of 'domestic company' and 'external company' in s 1 of the Act

¹⁵⁷ Sec 9(1)(b) of the Act.

¹⁵⁸ 5th Katz Commission Report at 6.3; the Commission recommended that this exclusion should be removed from the ambit of s 9(1)(b) of the Act.

payment or periodical payments, is taxable in South Africa only if the natural source of the income is in South Africa.¹⁵⁹

As pointed out above, the consideration paid for downloading a computer program from a web site does not constitute the use of copyright and will only in very limited cases fall into the ambit of s 9(1)(b). Furthermore, the provision indicates that the use must be imparted for use in South Africa, which seems to indicate that where the use is imparted generally the provision would not apply. Almost all the information on the Internet is available to any user and would only in very limited cases be imparted for use only in South Africa. Therefore this provision will have very limited application in the context of electronic commerce. Even if the provision does apply, collecting the taxes would be very difficult, if not impossible.

The Katz Commission¹⁶⁰ criticises this provision, referring to the possibility that currently exists, that royalty payments may be classified as such under South African law, but not covered by South African tax treaties. For example, in the commentary to the tax treaty between South Africa and the United States it is stated that as the term royalties is defined in the Convention it is therefore independent of domestic law.¹⁶¹ The Commission recommended that, for ease of understanding and international compatibility, the OECD Model Convention definition of royalty should be used.

5.4.2 Sec 9(1)(bA)

An amount received or accrued to any person would be deemed to be from a South African source if it was received or accrued by virtue of:

'the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information for use in the Republic, or the rendering of or undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information, wheresoever such knowledge or information has been obtained from or such knowledge or information has been imparted or such assistance or service has been rendered or is to be rendered or any such undertaking has been given, and whether payment for such information, knowledge, assistance, service or undertaking has been made or is to be made by a person resident in or out of the Republic'

Section 9(1)(bA) differs from s 9(1)(b) in that it is not confined to any limited use, it includes consideration for the outright and once-and-for-all passing on of know-how.¹⁶² The provision also applies wherever the know how has been obtained or

¹⁵⁹ Meyerowitz at 7.26 & 9.60; The income seems to be considered royalties and not income from the sale of goods; see further ITC 1190 & ITC 1193 for examples of use.

¹⁶⁰ 5th Katz Commission Report at 6.3

¹⁶¹ At a 12 para 2; The terms used in the definition, not defined in the Convention, may be defined under domestic law.

¹⁶² Ibid at 7.27

has been or is to be imparted, or the assistance has been or is to be rendered or the undertaking has been given, and whether the payments have been or are to be made to a resident or non-resident.¹⁶³ The fact that the parties concerned are non residents and that the know-how is not put into use in South Africa does not render the provision inapplicable.¹⁶⁴

Horak¹⁶⁵ is of the opinion that this provision aims to encompass the imparting of knowledge (and services connected therewith), but not the product of the knowledge. This implies that the mere granting of a right to use the product of the knowledge (eg computer software) could not fall within the scope of this provision. In many tax jurisdictions payments for the right to use know-how are subject to withholding tax and tax authorities in these jurisdictions have raised the argument that even if the transfer of a software package does not constitute the grant of any significant right to use the copyright, it nevertheless constitutes the grant to use the know-how, and subsequently the product of revenue can be subject to withholding tax on that basis.¹⁶⁶ In this regard De Hosson makes the following remark:

*'I would consider this [above] approach as erroneous. 'Know-how' in the software context would normally be know-how concerning the programmer's art. If a software company were to provide instructions or training to software developers... perhaps the jurisdiction from which the payment emanates could regard the transfer as a transfer of know-how. But a user of a software program product learns no more about the programmer's art than the patient taking a patented drug understands how the drug is compounded. A software product may allow a user to edit faster, add faster or manipulate data more rapidly, but it teaches the user nothing about good grammar, mathematic principles, organisation skills or how to write a software program'*¹⁶⁷

It could therefore be suggested that neither the consideration paid for downloading a software program, nor the instructions provided therewith, would fall under s 9(1)(bA). The proposed US '*Regulations on Computer Program Transactions*' seems to follow the same approach in treating the '*provision of services for the modification of the program (and) the provision of know-how regarding computer programming techniques*' in the same manner as transfer of a computer program.¹⁶⁸

Furthermore, it is suggested, that as almost all of the '*knowledge and information*' mentioned in this provision could be digitised and could therefore be the object of electronic commerce. The question regarding the application of the provision would again be answered by examining the underlying contract and the facts and

¹⁶³ Ibid.

¹⁶⁴ The prospect of the Revenue authorities to collect this tax successfully is questionable.

¹⁶⁵ At 5.

¹⁶⁶ See Hosson as quoted by Horak at 5.

¹⁶⁷ Ibid.

¹⁶⁸ Prop Treas Reg s 1.861 - 18.61 as quoted in the Treasury Paper at 7.3.3

circumstances of the case. It should be kept in mind that, when this knowledge and information are available on an open network (like the Internet) and therefore generally available, the provision would not apply.

The Katz Commission levels the same criticism against this provision as against s 9(1)(b) of the Act, recommending that the OECD Model Convention definition of royalties should also replace this provision.¹⁶⁹ The OECD definition makes no reference to services and the Commission recommended that the inclusion of services is inconsistent with the basic distinction between active and passive income. By removing services from the provision current uncertainties would be reduced and the system would find a functional resonance with international norms and practises.

The IFA, during its 51st annual congress in New Delhi (October 1997), adopted a final resolution calling on international organisations (like the OECD and the UN) to formulate guidelines to distinguish between know-how, technical services and other services.¹⁷⁰ Therefore the international trend seems to be to include know-how in a wider royalties definition and to exclude services from such a definition.

5.4.3 Section 35

Section 35 of the Act imposes a withholding tax in respect of royalties that has been received by or accrued to a non-resident¹⁷¹ or a non-domestic company.¹⁷² The provision only applies to royalties that are deemed to be from a South African source, by virtue of s 9(1)(b) and s 9(1)(bA). In many of the DTAs South Africa concluded, this withholding rate on royalties is reduced or eliminated and will be discussed in the Chapter 6.

5.5 Sections 9C - Investment income from foreign sources.

Following the 5th Katz Commission Report, the Legislator introduced measures to ensure that certain categories of foreign passive investment earned by South African residents (directly or indirectly) are deemed to be from a South African source. These new provisions are contained in s 9C and s 9D of the Act, while s 64A and s 64B of the Act have been amended to link these with the new

¹⁶⁹ 5th Katz Commission Report at 6.3(ii).

¹⁷⁰ IFA 51st Congress, October 1997 Sub I Res IIA.

¹⁷¹ Sec 35(1); not being a person who is ordinarily resident in South Africa, see further Meyerowitz at 13.10

¹⁷² Sec 35(1) refers to 'not... a domestic company' and s 35(2) refers to 'not... a company which has its place of effective management inside the Republic', which is clearly different from a non-domestic company. 'Effective management' is a term used in a number of double taxation agreements to determine the residence of a company for purposes of the agreement, the term is also used in the OECD Model Taxation Convention. A 'domestic company' is defined in s 1 of the Act as 'a South African company which is managed and controlled in the Republic'. It is submitted that this technical difference between the definitions could lead to uncertainty. Mazansky at 5 accepts that the two places will in most cases be the same, but points out the UK Revenue authorities accepts that effective management may, in some cases be found at a place different from the place of central control and management, eg where a company is run by executives based abroad but the final directing power rests with non-executive directors who meet in the UK.

provisions. The affected persons are South African residents¹⁷³ and non-residents are only affected to the degree that income is connected to a 'permanent establishment' in South Africa. The affected income is investment income, defined in s 9C to be:

'any income in the form of any annuity, interest, rental income, royalty or any income of a similar nature from a foreign country.'

5.5.1 Section 9C

This provision deals with investment income earned directly. Where investment income (as defined) is received by or accrues to a resident (as defined) or a non-resident (where the income arose from the activities carried on by him/her through a permanent establishment situated inside South Africa) from a source outside South Africa, it is deemed to have been received or accrued from a South African source.¹⁷⁴ This provision will not apply to investment income connected with a resident's permanent establishment outside South Africa, provided that the establishment is suitably equipped for conducting a substantive business enterprise and the income is effectively connected to the business activities of such resident.¹⁷⁵

This provision introduces new concepts and definitions into the Act, and also creates new problems in the context of electronic commerce. A comprehensive analysis of this provision is beyond the scope of this Paper and only the problems in an electronic commerce context will be examined. These problems are as follows:

- Persons, other than natural persons, must have its *'place of effective management'* in South Africa to be effected by s 9C. As pointed out above the place of *'effective management'* of a company that conducts electronic commerce from a website (that being its only business), could be problematic to determine. It is suggested that the day-to-day running of such a company could not take place at any other place than at the location of the server hosting the website. If this website is accessed for updating, changes etc., from a foreign location by, say one of the directors, it could be argued that the day-to-day running of the company is taken place from that foreign location. It is unclear whether *'manage and controlled'* should in all circumstances be human activity.
- The term *'permanent establishment'* is defined in s 9C(1) with reference to Art 5 of the OECD Model Tax Convention. Mazansky¹⁷⁶ points out, and it is suggested correctly so, that there is a degree of awkwardness in importing a definition of this nature verbatim into the South African domestic tax law. The OECD Model

¹⁷³ Residents are defined in s 9C as 'any natural person who is ordinarily resident in the Republic and any person other than a natural person which has its place of effective management in the Republic'.

¹⁷⁴ Sec 9C(2).

¹⁷⁵ Sec 9C(3)(a).

¹⁷⁶ As quoted by Van Blerck and Horak at 10.

is a model for agreement between Contracting States and at times inappropriate for a domestic tax provision, eg the usage of the term '*Contracting State*' which has no relevance at all to the domestic provision. The Katz Commission, in fact, recommended that the OECD Model and UN Model definitions would provide the basic concepts and terminology for the South African legislation, and not that the definition should be used without any adaptation.¹⁷⁷ The Commission touched on the effect that electronic commerce could have on the definition of a '*permanent establishment*' and recommended that the degree of '*fixedness*' implicit in the definition is no longer appropriate in light of modern trade practises:

*'While the concept of some relevant presence needs to be retained, the Commission feels that the degree of 'fixedness' required by the treaty definition does not recognise the technological advances which have made possible facilities such as a 'mobile office'. It therefore recommends that the definition be adjusted by removing the requirements that there be a 'fixed' place of business, and that in its place be put the requirement of a business facility 'suitably equipped' for the particular business'*¹⁷⁸

It is suggested that the incorporation of this '*suitably equipped*' requirement in the definition of a '*permanent establishment*' in s 9C would have made it possible to consider a server located in South Africa as a '*permanent establishment*' for the purposes of this provision and therefore bring extra revenue into the South African tax net.

The legislature only incorporated the '*suitably equipped*' principle in s 9C(3)(a) which deals with residents not affected by the provision. Van Blerck and Horak¹⁷⁹ argues that the '*suitable equipped*' requirement is a '*belt and braces*' provision that meshes in with the other requirements and which ensures that the concept of substance inherent in the term '*substantive business enterprise*' can be subject to an objective test. This objective test would involve an examination of all the resources, including technological, available to the enterprise. A website on a server would probably be regarded as suitably equipped for the purposes of electronic commerce.

It is therefore suggested that the '*permanent establishment*' test embodied for an affected non-resident in s 9C(2)(b) could exclude a domestic computer server, but that the '*permanent establishment*' test for a non-affected resident in s 9C(3)(a) could include a foreign computer server. The reasoning behind this bizarre difference is unclear. This implies that a resident operating a web site from a server outside South Africa would not be taxed on royalty income flowing from that business into South Africa,

¹⁷⁷ 5th Katz Commission Report at 5.3.1

¹⁷⁸ *Ibid* at 5.4.1.1

¹⁷⁹ At 27

because that foreign server is '*suitably equipped*' and therefore a '*permanent establishment*' in terms of s 9C(3)(a). For that reason the provisions of s 9C would not apply. On the other hand a non-resident operating a web site from a server in South Africa would not be considered to have a '*permanent establishment*' because there is no '*suitably equipped*' requirement in s 9C(2)(b) and therefore the provision of s 9C would also not apply.

- Section 9C(3)(a) deals with persons not affected by the provision and introduce the concept of '*substantial business enterprise*'. This concept seems new to the South African tax legislation. An electronic and manual search by both the author and Van Blerck and Horak¹⁸⁰ in local and international legislation, agreements and reports failed to locate the term. It is used in the new Double Taxation Agreement with Japan signed in March 1997, but the term is not defined in the agreement. The Katz Commission Report only discussed the term with reference to Controlled Foreign Corporations (CFC) and the UK rules towards CFCs.¹⁸¹

From the abovementioned it is clear that s 9C creates substantial problems in the context of electronic commerce. These problems seems to revolve around the question whether a server could be regarded as a '*permanent establishment*' or not and is discussed in Chapter 6.

5.6.1 Services - natural source

It is an established principle in South African tax law that the source of income from services rendered or work done is located where the services are rendered or the work is done, whether they are mental or physical.¹⁸² The originating cause is the rendering of the service or work done, which is the *quid pro quo* in respect of which the income is received.¹⁸³

When this principle is applied to electronic commerce, it is suggested that any on-line services are performed at the server which hosts the web site. Again we are faced with the problem whether the '*work done*', contemplated in case law, is only confined to human activity and whether '*work done*' by a computer should also be taken into account. Another argument could be that on-line services are done where the web site is accessed. This would however, lead to a situation where an on-line taxpayer would be rendering services in every single country in the world where the website can be accessed from.

¹⁸⁰ Van Blerck and Horak at 23.

¹⁸¹ 5th Katz Commission Report at 8.3.1.1

¹⁸² Meyerowitz at 7.51; Huxham & Haupt at 2.4.8; Millin v CIR 1928 AD 207; CIR v Lever Brothers & Another 1946 AD 441 at 450; CIR v Epstein 1954 (3) SA 689 (A); COT v Shein 1958 (3) SA 14 (FC) at 16 & 18.

¹⁸³ CIR v Lever Brothers & Another 1946 AD 441 at 450.

5.6.2 Services - deemed source

In terms of s 9(1)(d) of the Act an amount shall be deemed to have accrued to any person from a source within South Africa if it has been received by or accrued to or in favour of such person by virtue of:

*'any service or work or labour done by such person in the carrying on in the Republic of any trade, whether the payment for such services or work or labour is or is to be made by a person resident in or out of the Republic and wheresoever payment for such service or work or labour is or is to be made'*¹⁸⁴

There is a definite difference between this deeming provision and the natural source of services, in that for the purpose of the deeming provision even the place where the services are rendered does not directly matter.¹⁸⁵ The only requisite of s 9(1)(d) is that the income must have accrued to or received by the taxpayer by virtue of services rendered by him in the carrying on of a trade in South Africa. In regards to the natural source the place of the trade may or may not be the decisive test, but as regards the deeming provision the trade in South Africa is the absolute test.¹⁸⁶ It does not matter whether the payment is done by a person in or outside South Africa, where the service is rendered and where payment is made.¹⁸⁷

'Trade' is defined in s 1 of the Act to include:

'every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or grant of permission to use any patent as defined in the Patents Act 57 of 1978, or any design as defined in the Designs Act 57 of 1967, or any trade mark as defined in the Trade Marks Act 62 of 1963, or any copyright as defined in the Copyright Act 98 of 1978, or any other property which is of a similar nature'

It is suggested that this definition is wide enough to include all the know services currently available on the Internet.. In the case of *Burgess v CIR*¹⁸⁸ Grosskopf JA made the following observation on the nature of trade:

'It is well-established that the definition of trade, which I have quoted above, should be given a wide interpretation. In ITC 770 19 SATC 216 at 217, Dowling J said, dealing with the similar definition of 'trade' in Act 31 of 1941 that is was: 'obviously intended to embrace every profitable activity and... I think should be given the widest possible interpretation.'

¹⁸⁴ Sec 9(1)(d).

¹⁸⁵ Meyerowitz at 7.72

¹⁸⁶ Ibid.

¹⁸⁷ Ibid at 7.71

¹⁸⁸ 1993 (4) SA 161 (A) at 181; The case dealt with the deductibility of amounts under s 11(a) of the Act.

This wide interpretation could mean that even businesses situated outside South Africa could be considered to carry on a trade in South Africa, if such a business has a website hosted on a local server. It is furthermore suggested that even websites of foreign service providers accessed by South Africans, could mean that such businesses are carrying on a trade in South Africa, it being a profitable activity. The possibility of Revenue collecting these taxes is very limited indeed, even less so the possibility of determining the identity and location of these businesses.

As the deeming provision does not concern the location of the services rendered, amounts received for services rendered abroad could also be sourced in South Africa. In *ITC 878*¹⁸⁹ the Court was of the opinion that work outside South Africa had to be done as part of the taxpayer's trading in South Africa. In *ITC 1585*¹⁹⁰ Melamet J said that this provision was intended to apply where a taxpayer has a trade within South Africa and renders services outside South Africa as part of that trade and was not intended to apply where the taxpayer had two distinct businesses, one within and one outside South Africa. This is of particular relevance to taxpayers in South Africa who also own or control servers abroad. A Court could come to the conclusion that the income generated by such non-South African servers are deemed to be from a South African source by virtue of s 9(1)(d) as the services rendered from that foreign server forms part of the trade of the taxpayer in South Africa.

Amounts received by or accrued to non-residents from where-ever would not fall under this provision, it being immaterial where the services are rendered, whether the payment is made by a person in or outside South Africa or wheresoever such payment is made.¹⁹¹ But if such a non-resident renders services from a web site hosted on a server in South Africa, it would probably be carrying on a trade in South Africa and therefore the provision will apply.

This provision came under attack from the Katz Commission for inhibiting the smooth flow of trade and investment across South Africa's borders. It stated that:

*This provision seeks to extend the source of active or business income and has become all but unused in view of restrictive court interpretations of its terms. As will appear, it also runs counter to the notion proposed in this report;*¹⁹²

Although the Commission recommended that active income should continue to be taxed on a source basis, it further recommended that no detailed definition of source should be attempted, and instead the general concept used internationally of taxing business profits with reference to a combination of 'activity' linked to a

¹⁸⁹ 1959 Taxpayer 229, 23 SATC 230; Meyerowitz at 7.73

¹⁹⁰ 1996 Taxpayer 190, 57 SATC 81; Meyerowitz at 7.73

¹⁹¹ Meyerowitz at 7.71

¹⁹² 5th Katz Commission Report at 5.2.1(ii).

'permanent establishment' should form the basis of taxability.¹⁹³ Such an approach would ease the sourcing of electronic services income.

From the abovementioned it seems that the crisp issue is whether the existence of a commercial web site hosted on a server in South Africa implies that the owner thereof is carrying on a trade in South Africa. Given the wide interpretation of *'trade'* by the courts, it is suggested that it will and therefore s 9(d) would apply.

¹⁹³ *Ibid* at 9.2 & 9.3

CHAPTER 6 - DOUBLE TAXATION AGREEMENTS

A Double Taxation Agreement (hereinafter referred to as a 'DTA') is an international treaty concluded between two states to regulate the exercise of tax jurisdiction by the two states.¹⁹⁴ The purpose of such agreements are usually expressed in the preamble to be *'the avoidance of double taxation and the prevention of fiscal evasion'*. In the absence of such a treaty double taxation may arise because of the overlap of the taxing jurisdiction of each state. In terms of s 108(1) of the Act and s 241 of the Constitution,¹⁹⁵ the South African Government may enter into agreements with the governments of other countries, with a view to the prevention, mitigation or discontinuance of the levying, under the laws of South Africa and that other country, of tax in respect of the same income. As soon as the agreement has been approved by Parliament, the agreement must be notified by publication in the Government Gazette and thereafter the agreement have the effect as if enacted in the Act.¹⁹⁶

The concepts of *'permanent establishment'* and *'fixed base'* in DTAs are very important, since they determine which of the two treaty countries has the primary right to tax the income. If a resident of one country has activities that pass the threshold to constitute a *'permanent establishment'* or *'fixed base'* in the source country, the source country will have the primary right to tax the income and the resident country will be obliged to give relief from double taxation.¹⁹⁷ In the context of electronic commerce the vital question would be whether a server hosting a website in a specific country constitutes a *'permanent establishment'* or a *'fixed base'* in that country.

The global and borderless nature of the Internet and the fact that electronic commerce can take place between taxpayers situated anywhere in the world, emphasises the importance of DTAs in the taxation of electronic commerce. In this regard the Katz Commission came to the following conclusion:

*'...it can be reasonably assumed that much of this [electronic commerce] tax evolution will take place through treaty negotiations around concepts like permanent establishment definitions, attribution rules, or exemptions or credits affecting passive income.'*¹⁹⁸

The US Treasury echoed this view by identifying the role of tax treaties as one of the most substantive issues on the taxation of electronic commerce.¹⁹⁹

¹⁹⁴ Eskinazi at 1.

¹⁹⁵ 108 of 1996

¹⁹⁶ Sec 108(2).

¹⁹⁷ Meyerowitz at 30.14; Eskinazi at 5.

¹⁹⁸ 5th Katz Commission Report at 7.4.2

¹⁹⁹ Treasury Paper at 7.1.4 & 7.2.2

Concepts in DTAs, like *'business of an enterprise'*, *'permanent establishment'*, *'fixed base'*, *'independent personal services'*, *'business profits'* and *'royalties'*, will be examined in this Chapter and applied to electronic commerce. Because of the virtual monopoly the United States continues to have on electronic products and services, special attention would be given to the new DTA between South Africa and the United States. Furthermore reference would be made to the Commentary on these concepts in the various Model treaties. These model treaties include the OECD Model, the UN Model and the US Model treaties.

In general all the DTAs South Africa entered into provide that a concept or term used in a DTA but not defined therein, will have the meaning that it has under the law of the country whose tax is being applied. Therefore terms and concepts not defined in the relevant DTA would have their South African meaning and definition in this Chapter.

6.2 Permanent Establishment (PE)

The concept of *'permanent establishment'* determines which of the two treaty countries has the primary right to tax income. Therefore it is important to test the economic activity that gives rise to the income against the definition of a PE. If the activity passes the PE threshold in the source country, that country would have the primary right to tax the income. In a typical DTA the PE concept relates to the taxation of business profits, dividends, interest, royalties, capital gains and dependant personal services, amongst others. For the purposes of this Paper the taxation of business profits, royalties and dependant personal services are relevant.

It is suggested that the PE concept as defined in the OECD Model will be one of the concepts around which international consensus would seek to tax electronic commerce. Therefore the current OECD definition would be used as a starting point for this discussion. The OECD Model Tax Convention defines a PE in Article 5 as follows:

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

2. The term 'permanent establishment' includes especially:

a) a place of management;

b) a branch;

c) an office;

d) a factory;

e) a workshop; and

f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construct or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of the Article, the term 'permanent establishment' shall be deemed not to include:

a) the use of facilities solely for the purpose of storage, display or display of goods or merchandise belonging to a enterprise;

b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;

c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;

f) the maintenance of a fixed place of business solely for any combination of these activities mentioned in sub-paragraphs a) to e) provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person (other than an agent of an independent status to whom paragraph 6 applies) is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, the enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that state through a broker, general commission agent or any other agent of an independent status, provided such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

6.2.1 Business of the enterprise

In *Secretary for Inland Revenue v Downing*²⁰⁰ Corbett JA, in dealing with the definition of a PE in the DTA between South Africa and Switzerland, held that:

'It is clear from art 7(1) [art 5(1) of the OECD Model] that, in order for the business profits of a Swiss resident to be taxable in South Africa, it must appear -

- (a) *that he has carried on business in South Africa; and*
- (b) *that the business has been carried on through a permanent establishment situated in South Africa.*²⁰¹

Therefore, before the PE issue can be answered, the first question to be answered is whether the taxpayer in question carried on a business by having a website hosted on a server in the relevant country.

The term '*carrying on a business*' is neither defined in any of the DTAs South Africa concluded nor in any of the Model Conventions or the Commentaries thereto. Therefore, the South African law could be applied as to the meaning of the term.

The definition of '*trade*' in s 1 of the Act enumerates a number of activities. As '*business*' is merely one of them, it could be argued that the legislature did not intend the term in a wide sense.²⁰² The courts have, however, not approached the question in this way and the general view seems to be that the words should be given their ordinary signification in the commercial sense.²⁰³

²⁰⁰ 1975 (4) SA 518 (A)

²⁰¹ 1975 (4) SA 518 (A) at 52

²⁰² Meyerowitz at 13.11

²⁰³ Ibid; Joel & Joel v CIR 1922 WLD 35

From a reading of the cases²⁰⁴ dealing with the term, it is suggested that there is no justification why selling goods or providing services electronically should not be considered the carrying on of a business.

The term '*enterprise*' is not defined in any DTA or Model Convention but is understood to refer to any activity that constitute a trade or business.²⁰⁵

6.2.2 Could a server hosting a website constitute a PE?

The Katz Commission seems to have come to the conclusion that a server hosting a website in South Africa could not constitute a PE as defined in the OECD Model. It therefore recommended that the degree of fixedness does not recognise modern trade practises and technological advances. The Commission introduced the idea of a business facility that is '*suitable equipped*' for that particular business²⁰⁶ which would possibly push a server over the PE threshold. It should however be noted that these recommendations were made in relation to the taxation of investment income and were not implemented by the legislature in the definition of a PE in s 9C and 9D of the Act.

The OECD Commentary²⁰⁷ states that a PE may exist if the business is carried on mainly through automatic equipment, with the activities of personnel restricted to setting up, operating, controlling and maintaining such equipment. According to Goldberg & Alpert²⁰⁸ it appears that these Commentaries were focused on gaming and vending machines. Even in cases where a server can accept orders and deliver the goods, it is far from clear that the seller would have a PE in the country where the server is located.²⁰⁹

The Treasury Department is of the opinion that persons engaged in electronic commerce may not have a US PE because they do not have a '*fixed place of business*' in the United States, unless a PE is created by imputation from an agents activities.²¹⁰ Agency issues could arise from the relationship between a foreign person and an ISP or telecommunications service provider.²¹¹ In most cases of electronic commerce, information will be transmitted to the customer's computer through telephone lines, eg a foreign person who operates a computerised research service might contact with a US telecommunications company to provide the local dial access service so that foreign persons and US customers can access the website or database. Alternatively, the foreign person might use an US-based ISP or customers might use such an ISP to access the website. In this example the ISP

²⁰⁴ Stephan v CIR 1919 WLD; Joel & Joel v CIR 1922 WLD 29; COT v Estate G 1965(1) SA 780 (SR); ITC 1179 35 SATC 38; ITC 1501 53 SATC 314; ITC 1529 54 SATC 252

²⁰⁵ Technical Explanation to US Treaty at a 3 para 1

²⁰⁶ 5th Katz Commission Report at 5.4.1.1

²⁰⁷ OECD Commentary a 5(4) para 10

²⁰⁸ Goldberg & Alpert at 3.

²⁰⁹ Ibid.

²¹⁰ Ibid at 7.2.5

²¹¹ For a discussion on the possible agency issues, see *Straight Talk: Internet, Tax and Interstate Commerce* published by the ITAA available at <http://www.ita.org/IP7.htm>

and the telecommunications company would not be regarded as agents of the foreign person, and even if they were deemed to be agents, they would certainly be independent agents, with the result that a PE would not arise.²¹² It is therefore suggested that the US Treasury Department came to the conclusion that, at least under current rules, the presence of a computer server in the US would not constitute a PE.

In South Africa the agency provisions in the PE definition came up for decision in *Secretary for Inland Revenue v Downing*.²¹³ In this case the respondent, a resident of Switzerland, left the management of his South African share portfolio in the hands of a stockbroker in South Africa. The question to be answered was whether the respondent was carrying on a business through a PE in South Africa. Corbett JA stated:

'It really amounts to deciding whether the facts found as the normal scope of a stockbroker's business bring the case within the provisions of para 5 [para 6 in the OECD definition] and, more particularly, within the ambit of the words "broker, general commission agent or any other agent of an independent status... acting in the ordinary course of his business": this is, in my opinion, a question of law...

*The words "acting in the ordinary course of their business" are certainly capable of bearing the meaning ascribed to them by the Special Court, viz. doing what that particular type of agent..., normally does in the course of carrying on his business. Moreover, this would seem to be the natural meaning of these words*²¹⁴

It is therefore suggested that a website hosted on a server owned by an independent agent (like an ISP) would not constitute a PE, because hosting websites would certainly be what such agents do in the normal course of carrying on their business. In this context the US Treasury and the South African Courts come to the same conclusion.

Cigler, Burritt & Stinnet²¹⁵ came to much the same conclusion:

'It is unlikely that the solicitation of orders via the Internet could give rise to a PE generally seen as an auxiliary or preparatory activity. Likewise, making software or other products available over the Internet should not trigger a PE under current generally accepted definitions of a PE. However, if service companies are hired to process orders and clear payments, it could be concluded that such providers have sufficient authority to bind an enterprise

²¹² Treasury Paper at 7.2.3.1

²¹³ 1975(4) SA 518 (A).

²¹⁴ Ibid at 527 & 528.

²¹⁵ Cigler, Burritt & Stinnet at 12 & 13.

in the activity, which when exercised habitually could give rise to a dependant agent and therefore a PE.

Where an ISP runs a database for a foreign person, it could be argued that the service provider is only providing the foreign person with the 'use of facilities solely for the purpose of storage, display or delivery of goods'. Presuming that data are 'goods', it could be argued that the database is not used solely for storage, display or delivery, as the database can also be searched and manipulated and, therefore, could be considered a PE.

Since business is at least partly carried on in the country where the database is run, the question therefore becomes whether a computer could be considered 'a fixed place of business'. Under traditional views of what a fixed place of business is, it is unlikely. However, this question will be subject to interpretation by the tax authorities and Courts of each country, and it is likely that at least some countries will conclude that a computer can be considered to be a fixed place of business'

Goldberg & Alpert try to resolve the issue by comparing a server to a sales catalogue which is mailed into a state or, where the server can also deliver the goods, to a sales outlet.²¹⁶ In the case of the latter, a strong case could be made to constitute a PE, while the former would not constitute one.

Muscovitch²¹⁷ comes to the conclusion that a webpage could constitute a PE, but only in the country where the server is located:

'Does a web page have a physical presence of some permanence? The best answer seems to be that a web page can have a physical presence. A web page is made from binary, or digital code, and is housed on a magnetic surface, usually a disk of some kind. The binary code is viewed using a computer and a communications device. However, even though we can establish a physical presence, albeit a brand new form, the "establishment" exists on the host computer [or server]. Therefore, a web page will likely constitute a permanent establishment only in the country where the host computer resides'

Ward²¹⁸ is also of the opinion that a server would not constitute a PE. He comes to this conclusion by applying English case law relating to VAT and the 'fixed establishment' concept. The American Bar Association suggests that a computer server would probably not be a PE, except in the case where a person is selling the use of the server itself, as opposed to making use of the server to sell other products and services.²¹⁹

²¹⁶ Goldberg & Alpert at 4.

²¹⁷ At 8.

²¹⁸ Ward at 3.

²¹⁹ Karlin at 6.

In October 1996 the Second Chamber of the German Supreme Tax Court rendered its decision in a case which came to be referred to as the *'pipeline case'*.²²⁰ The court concluded that a Dutch company who controlled and owned an oil pipeline in Germany had a PE in Germany, although the company had no employees in Germany and all its technical and marketing personnel were situated in the Netherlands. All the maintenance and repairs to the pipeline were done by independent contractors in Germany. Hey²²¹ points out that what is clear from the decision is that no employees or physical presence by the taxpayer was necessary to render a pipeline, controlled from another country a PE, nor was it necessary that the PE be visible. He applies this case to electronic commerce as follows:

*'A vendor's home page on the Internet and the access the Internet provides to that home page do not give rise to a permanent establishment, since the vendor does not have control over any of the appliances necessary for data transmission in Germany. In other words an Internet Service Provider may have a permanent establishment in Germany, but not a vendor who uses the communications system.'*²²²

During the 1997 IFA Congress when it was discussed whether a server could qualify as a PE, no conclusions could be reached and it was recommended that IFA and the OECD further study these questions.²²³ The Turku Paper²²⁴ identified a number of issues that would guide the OECD in deciding whether refinements or changes in the definition of a PE would be in order. These lengthy issues could be summarised as follows:

- The first issue is whether the general conditions for the existence of a permanent establishment may be satisfied by a web site on a server owner or used by a foreign enterprise, taking into account that there would not necessarily be any employees of the enterprise present in the source country. This requires a determination of whether such a site constitutes a *'place of business'*, whether the server can then be said to be *'fixed'* and whether the undertaking of periodical automated business functions may be said to constitute the *'carrying on of a business'* through such a fixed place of business.
- The determination of whether the server constitutes a *'fixed place of business'* must take into account various possibilities. For instance, a server may be located in a building in a country where the enterprise has no other presence. Alternatively, it could be located on a portable laptop computer used in different places. Further difficulties would arise where a number of mirror web sites on different servers located in different countries would be used so that a customer could be directed to any server depending on electronic traffic. Another

²²⁰ Hey at 1; Unreported decision of October 30, 1996, II R12/96, *Betriebs-Berater* at 138.

²²¹ At 4.

²²² *Ibid* at 5.

²²³ Bracewell-Milnes & Jager.

²²⁴ At 24.

possibility would be to have only one website which is electronically transferred to another server in another country every 182 days.

- The ownership of the website contents or data and the ownership of the server would also be relevant. For instance, the enterprise could own the web site but lease the server from a service provider, lease both the web site and the server from the service provider or lease the web site and server and share various functions with the service provider or other web site owners.
- Another issue is whether the activities carried on through a web site go beyond the types of preparatory and auxiliary activities which would not result in a PE. This issue has to be addressed with respect to the various functions that can be automated, such as advertising, ordering, payment, storage and digital delivery as well as with respect to various combinations of these functions. It also requires a determination of the extent to which a database of digital content may be said to constitute a stock of goods and, if that is the case, whether the database may be said to be maintained solely for the purpose of storage, display or delivery if it also has a search and reporting facility. Particular issues arise in respect of the exception, included in sub-para 4(d), concerning the collection of information as it is not clear at what point mere collection of information substantially becomes processing of raw information collected, which may render the exception inapplicable.
- If the functions performed through a web site and a server were such that they did not constitute a PE, there would also be a need to examine whether or not any other activities were carried on through that server, eg where the enterprise would lease excess capacity on its server to another enterprise to operate a web site.
- Other issues arise with respect to the relationship between an enterprise that owns a web site and the ISP, the questions being whether or not and to what extent the latter may be considered to be an agent of the former.
- If it is determined that a web site is a PE, it is necessary to determine the income attributable to that PE. Particular difficulties could arise in these cases because there are no branches in the traditional sense and therefore no branch account operations between the branch and the head office which could be used as the starting point. In addition, it might be difficult to determine the functions and transactions that should be attributed to the operations of the PE if mirror web sites in other countries are used to handle transactions when the web site in question redirects the transactions because of traffic volumes.

It seems clear from the aforesaid that neither a server hosting a website nor access to such a website would constitute a PE in most countries under current rules. The fact that some countries might treat a server differently than others for tax purposes

is worrisome in an international tax context. Because servers are entirely mobile, they would be rushed to countries where they would not be considered PEs, eg to escape withholding taxes. The same principles would apply for purposes of s 9C and 9D of the Act. The mobile nature of electronic commerce necessitates a uniform international approach in this regard. In light of these issues, the OECD Working Group on Permanent Establishment is currently examining the changes to be considered to the definition of a PE.²²⁵

6.2.3 Business Profits

The general principle in DTAs is that the '*business profits*' of a resident of one state, shall only be taxable in that state unless that resident carries on business in the other state through a PE situated therein, but only so much of the profit as is attributable to that PE.²²⁶

Most DTAs and Model DTAs does not define '*business profits*'. However, the US Model Treaty defines the concept as income from any trade or business, including income derived by an enterprise from the performance of personal services, and from the rental of tangible personal property.²²⁷ The Treaty between South Africa and the US does not define the concept, but from reading the Technical Explanation to the Treaty, it is clear that the same definition as set out in the US Model Treaty is applied.²²⁸ Income received for the transfer of '*shrink-wrap*' computer software is considered to be '*business profits*' in the US Model Treaty²²⁹ and it is suggested that this is internationally accepted to be the situation with software that is bought and delivered electronically. Cigler, Burritt & Stinnet suggest that '*business income*' means the same as active income.²³⁰ Some DTAs treat '*business income*' as '*industrial and commercial profits*' and give detailed definitions of what these profits include, eg the DTAs with Botswana,²³¹ Germany,²³² Malawi,²³³ Namibia,²³⁴ Uganda & Tanzania,²³⁵ the United Kingdom,²³⁶ Zambia,²³⁷ and Zimbabwe.²³⁸ In

²²⁵ The Turku Paper at 26.

²²⁶ See eg the South Africa/United States Tax Treaty at a 7(1) and the OECD Model at a 7(1).

²²⁷ US Model Treaty a 7 para 7; Income derived by persons other than individuals or groups of individuals (eg a partnership) from the performance of independent personal services is regarded as business profits.

²²⁸ Technical Explanation at a 7 para 1.

²²⁹ US Model Treaty Commentary at a 12 para 2.

²³⁰ Cigler, Burritt & Stinnet use the concepts of 'business income' and 'active income' in the same sense.

²³¹ At a 6(6).

²³² At a 4(1); This provision refers to 'industrial and commercial profits' but provides no definition.

²³³ At a 2(1)(j).

²³⁴ At a 2(1)(j).

²³⁵ At a 2(1)(i).

²³⁶ At a 6(6).

²³⁷ At a 2(1)(j).

²³⁸ At 2(1)(i)

*Commissioner of Taxes v Aktiebolaget Tetra Pak*²³⁹ Beadle CJ held that the term 'industrial and commercial profits' should be given a wide meaning:

'...in deciding whether or not any enterprise is a "commercial" one, the question might well be asked: Is this sort of enterprise which, in commercial life, would be regarded as such?'

The question whether income from services provided by companies should be regarded as 'business profits' or 'independent personal services' seems unclear. The issue is of importance because 'business profits' relates to the PE concept, while 'independent personal services' usually relates to the concept of a 'fixed base' in most DTAs. This issue came up for discussion during the 1997 IFA Congress,²⁴⁰ where it was concluded that from an academic point of view Article 14 (Independent personal services) in the OECD Model applied to companies, but was in practice not applied to companies²⁴¹ and only applied to individuals and partnerships.

It is suggested that this issue be resolved by application of the relevant DTAs between the States concerned,²⁴² and if that is not possible by mutual agreement between the competent authorities.²⁴³

As business profits are linked to the 'permanent establishment' concept, it is suggested that non-residents earning 'business profits' through a website hosted on a server located in South Africa, would not be taxed thereon in South Africa.

6.2.4 Royalties

In most DTAs royalties derived by a resident of a certain state, shall only be taxable in that state. This is referred to as the 'exclusive taxation of royalties' in the state of resident.²⁴⁴ This provision will not apply if the owner of the royalties carries on business through a PE or performs independent personal services from a fixed base situated in the source state and the royalties are attributable to that PE or 'fixed base'.²⁴⁵

In the DTA between South Africa and the United States the term 'royalties' is defined in Article 12(2) as:

²³⁹ 1966 (4) 198 (R AD)

²⁴⁰ Bracewell-Milnes & Jager.

²⁴¹ Ibid; only Canada and Turkey applied Article 14 to Companies.

²⁴² The Tax Treaties South Africa concluded with the United States, Botswana and the UK, include 'personal services' in the definitions of 'business profits'. The Treaties with Botswana and the UK use the concept of 'services of employees or other personnel' which seems to indicate that only the services of non-individuals falls under the 'Business profits'-provision. The Treaties with Malawi, Namibia, Zambia and Zimbabwe expressly exclude 'remuneration for personal service' from the definitions of 'Business profits'.

²⁴³ Article 25 of the South African/United States Tax Treaty provides for such a Mutual Agreement Procedure.

²⁴⁴ OECD Model Commentary a 12 para 1(1).

²⁴⁵ Ibid a 12 para 3

'(a) any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including computer software, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience; and

(b) gain derived from the alienation of any property described in subparagraph (a), provided that such gain is contingent on the productivity, use, or disposition of the property.'

The OECD definition of royalty included consideration for the use of certain equipment as royalties but was amended in 1992 to exclude rental income from the 'use of industrial, commercial, or scientific equipment', and income from the use of such equipment is now treated as business profits.²⁴⁶ It should be noted that a large number of OECD member countries had reservations indicating that they wished to continue defining rental income from such equipment as royalties and continue imposing withholding taxes thereon.²⁴⁷

During the 1997 OECD Conference in Turku (Finland) it was concluded that:

*'Given the unique characteristics of digitised information and the difficulties of characterisation that could arise, the Committee is examining how to further clarify the definition of royalties in the Model Convention'*²⁴⁸

Most double taxation agreements reduce or eliminate the withholding tax on royalties provided that the foreign taxpayer is taxed in his/her home country on the income.²⁴⁹ In DTAs concluded with most of South Africa's treaty partners the withholding rate is eliminated, with the exception of Botswana,²⁵⁰ Canada,²⁵¹ Croatia,²⁵² the Czech Republic,²⁵³ India,²⁵⁴ Japan,²⁵⁵ Korea,²⁵⁶ Lesotho,²⁵⁷ Malta,²⁵⁸ Poland,²⁵⁹ Romania,²⁶⁰ Singapore,²⁶¹ and Taiwan.²⁶²

²⁴⁶ Sasseville at 'Definition of royalties'.

²⁴⁷ Ibid.

²⁴⁸ The Turku Paper at 27.

²⁴⁹ Cleaver & Hutton at 9.

²⁵⁰ At a 11(2); The maximum royalty withholding rate is 15%, however South Africa has unilaterally reduced the withholding rate to 12% in 1994.

²⁵¹ At a 12(2); A 10% withholding rate applies if the royalty is taxable in the recipient's country of residence, while a 6% withholding tax applies only to cinema and television royalties.

²⁵² At a 12; A 5% withholding rate applies if the recipient is a resident of the other state, the royalty is not effectively connected with a permanent establishment in the state where they arose and the recipient is the beneficial owner of the royalties.

²⁵³ At a 12; A 10% withholding rate applies when the recipient is a resident of the other state, the royalty is not effectively connected to a permanent establishment in the state where it arose, and the recipient is the beneficial owner of the royalties, otherwise a 12% rate applies.

²⁵⁴ At a 12; A 10% withholding rate applies when the recipient is a resident of the other state, the royalty is not effectively connected to a permanent establishment in the state where it arose, and the recipient is the beneficial owner of the royalties, otherwise a 12% rate applies.

Furthermore, a certain number of DTAs deem royalties to arise in a certain state. Of the Model Conventions only the UN Model contains this deemed source provision. According to Article 12(5) of the UN Convention:

'Royalties shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or resident of that State. Where, however, the person paying the royalties, whether he is a resident of the Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated'

The DTAs South Africa concluded with Austria, Canada, Croatia, Germany, the Czech Republic, Finland, France, Hungary, Israel, India, Japan, Korea, Lesotho, Malta, Poland, Romania, Sweden, Singapore, Thailand and Taiwan contain this deemed source provision where royalties are concerned.²⁶³

The effect of this deemed source provision is that royalties are sourced to the residence of the payer, irrespective of the fact that the transaction was concluded on the Internet and irrespective of the question whether a server constitutes a PE or not.

²⁵⁵ At a 12(2); A 10% withholding rate applies when the recipient is a resident of the other state, the royalty is not effectively connected to a permanent establishment in the state where it arose, and the recipient is the beneficial owner of the royalties, otherwise a 12% rate applies.

²⁵⁶ At a 12(2); A 10% withholding rate applies when the recipient is a resident of the other state, the royalty is not effectively connected to a permanent establishment in the state where it arose, and the recipient is the beneficial owner of the royalties, otherwise a 12% rate applies.

²⁵⁷ At a 12(2); A 10% withholding rate applies when the recipient is a resident of the other state, the royalty is not effectively connected to a permanent establishment in the state where it arose, and the recipient is the beneficial owner of the royalties, otherwise a 12% rate applies.

²⁵⁸ At a 12(2); A 10% withholding rate applies when the recipient is a resident of the other state, the royalty is not effectively connected to a permanent establishment in the state where it arose, and the recipient is the beneficial owner of the royalties, otherwise a 12% rate applies.

²⁵⁹ At a 12(2); A 10% withholding rate applies when the recipient is a resident of the other state, the royalty is not effectively connected to a permanent establishment in the state where it arose, and the recipient is the beneficial owner of the royalties, otherwise a 12% rate applies.

²⁶⁰ At a 12(2); The maximum royalty withholding rate is 15%, however South Africa unilaterally reduced its rate to 12%.

²⁶¹ At a 12; A 5% withholding rate applies when the recipient is a resident of the other state, the royalty is not effectively connected to a permanent establishment in the state where it arose, and the recipient is the beneficial owner of the royalties, otherwise a 12% rate applies.

²⁶² At a 12(2); A 10% withholding rate applies when the recipient is a resident of the other state, the royalty is not effectively connected to a permanent establishment in the state where it arose, and the recipient is the beneficial owner of the royalties, otherwise a 12% rate applies.

²⁶³ Most of these deemed source provisions are in s 12 of the relevant agreement, with the exception of Germany in a 9(4). See also para 6.2.3.4 of this Paper.

6.2.4.1 Royalties: Computer Software

A limited number of DTAs deal with the question of computer software. In the DTA between South Africa and the United States 'royalties' are defined to include the use of computer software.²⁶⁴ In the Technical Explanation to this treaty it is stated that:

'Under the Convention consideration received for the use or the right to use computer programs is treated as royalties or as income from the alienation of tangible personal property, depending on the facts and circumstances of the transaction giving rise to the payment. In determining whether such a payment should be considered a royalty, the most important factor is whether the transaction is properly characterised as involving the transfer of rights substantially equivalent to rights in a material object in which the copyrighted program is embodied, that is, program copy, or rights in the underlying copyright to the program. The fact that the transaction is characterised as a license for copyright law purposes is not dispositive. For example, a typical retail sale of a 'shrink wrap' program generally will not be considered to give rise to royalty income.

The means by which the software is transferred is not relevant for the purposes of this analysis. Consequently, if software is electronically transferred but the rights obtained by the transferee are substantially equivalent to the rights in the program copy, the payment will be considered income from the alienation of personal property.²⁶⁵

Currently only the DTAs with Canada,²⁶⁶ the Czech Republic,²⁶⁷ Japan,²⁶⁸ Lesotho,²⁶⁹ Mauritius,²⁷⁰ Thailand,²⁷¹ and the United States²⁷² have the use of computer software as part of the 'royalties' definition and it is suggested that the same principles would apply as quoted above.

6.2.4.2 Royalties: Know-how

DTAs also consider payment for information concerning industrial, commercial or scientific experience as royalties, which alludes to the concept of 'know-how'. Payments as consideration for after-sales service, for services rendered by a seller

²⁶⁴ At a 12.

²⁶⁵ Technical Explanation at a 12 para 2.

²⁶⁶ At a 12(2)(ii).

²⁶⁷ At a 12(3).

²⁶⁸ At a 12(3), this DTA only refers to 'software' and not 'computer software'.

²⁶⁹ At a 12(3).

²⁷⁰ At a 12(2).

²⁷¹ At a 12(2).

²⁷² At a 12(2)(a).

to a purchase under a guarantee, for pure technical assistance, or for an opinion given by an engineer, advocate or accountant, does not constitute royalties.²⁷³

6.2.4.3 Royalties: The use of equipment

The fact that some DTAs concluded by South Africa include the '*use or right to use, industrial, commercial or scientific equipment*' as part of the royalties definition could have far reaching implications for electronic commerce, especially for ISPs. The following questions come to mind:

- Does a South African resident who has data hosted on the computer server of a foreign ISP, use the '*commercial*' equipment of that service provider?
- Does hosting data on a computer server constitute the use of that computer or does the owner of the server computer simply provide a service or lease 'space' on that computer to a client?

Neither the Commentary to the OECD Model (before the 1992 amendment) nor the UN Model provide any guidelines to answer these questions. Karlin²⁷⁴ suggests that the income ISPs receive for access to or the conveyance of data on the Internet, are payments for services and thus not for the use of their equipment. It is suggested that treaty partners will have to characterise the payments received by ISPs as either royalties (from the use of their equipment) or as payment for services. If such 'rental' payments would result in royalties, it would be very difficult, if not impossible, for a resident to know in what jurisdiction the service provider is located and whether to withhold tax and at what rate. The whole issue would also relate to the question whether a server computer constitutes a PE

Currently the DTAs South Africa concluded with Botswana,²⁷⁵ Canada,²⁷⁶ the Czech Republic,²⁷⁷ Germany,²⁷⁸ France,²⁷⁹ Hungary,²⁸⁰ Israel,²⁸¹ Japan,²⁸² Swaziland,²⁸³ Malawi,²⁸⁴ Zimbabwe,²⁸⁵ Poland,²⁸⁶ Romania,²⁸⁷ Switzerland,²⁸⁸ Taiwan,²⁸⁹

²⁷³ OECD Commentary a 12 para 2.

²⁷⁴ Karlin at 10.

²⁷⁵ Art 12(3)(a).

²⁷⁶ Art 12(3).

²⁷⁷ Art 12(3).

²⁷⁸ Art 9(2).

²⁷⁹ Art 12(2).

²⁸⁰ Art 12(2).

²⁸¹ Art 12(2).

²⁸² Art 12(3).

²⁸³ Art 12(3).

²⁸⁴ Art 6(2).

²⁸⁵ Art 6(2).

²⁸⁶ Art 12(3).

²⁸⁷ Art 12(3).

²⁸⁸ Art 12(2).

²⁸⁹ Art 12(4).

Thailand,²⁹⁰ the United Kingdom²⁹¹ and the Netherlands²⁹² include the 'use of industrial, commercial and scientific equipment' in the definition of royalties. In the remaining DTAs payment for the use of equipment will in most cases be treated as business profits or as personal services.

6.2.4.4 Royalties: Technical Services

Unlike all the other DTAs South Africa concluded, the DTA with India²⁹³ levies a withholding rate of between 12% and 10% on fees for technical services. This DTA treat royalties and fees for technical services in the same manner. Fees for technical services are defined in art 12(4) of the DTA as:

'payments of any kind received as a consideration for services of a managerial, technical or consultancy nature, including the provision of services by technical or other personnel, but does not include payments for services mentioned in Article 15 [Dependant Personal Services]'

It is unclear how this definition differs from that of 'Professional Services' in Article 14 of the DTA, which is defined to include:

'independent scientific, literary, artistic, educational or teaching activities as well as independent activities of physicians, lawyers, engineers, architects, dentists and accountants.'

It seems that the difference lies in the use of the word 'independent' in Article 14, but surely the services contemplated in Article 12(4) could also be performed independently. Furthermore, these technical services are deemed to be sourced in either India or South Africa when:

*'the payer is the State itself, a political subdivision, a local authority or a resident of that State. Where however, the person paying... the fees for technical services, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base with which the... contract in respect of which the... technical fees are paid is effectively connected, and such... fees for technical services are borne by such permanent establishment or fixed base, then such... fees for technical services shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.'*²⁹⁴

The effect of this deeming provision is that the technical services provided by a South African resident and paid for by a resident of India will be sourced in India, irrespective of the fact that the services were provided electronically and irrespective

²⁹⁰ Art 12(3).

²⁹¹ Art 11(2).

²⁹² Art 12(3).

²⁹³ Art 12(2).

²⁹⁴ Art 12(6) of the DTA between South Africa and India.

of the location of the server making such services possible. The fees will also be sourced in India if a non-resident of that country has a permanent establishment of fixed base in India that borne that fees. Obviously it would be difficult for the competent authorities of both countries to enforce this provision, especially when the services are provided electronically. Furthermore residents of both countries providing electronic services could construct the contract in such a way that the services fall under Article 14 of the treaty and so avoid the withholding tax. Nevertheless, to source services where the payer resides seems like an innovative way to source transactions conducted over the Internet.

6.3 Fixed-base or 183-day rule

Article 14 of the DTA concluded between South Africa and the United States states that:

'Income derived by an individual who is resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State, unless such services are performed in the other Contracting State and such individual has a fixed base regularly available to him in that other Contracting State for the purpose of performing his activities.'

Article 14 further states that only the income attributable to the 'fixed base' is taxable in the other state and that there is deemed to be a 'fixed base' if a resident of one state is in the other state for a period or periods exceeding in the aggregate 183 days in any 12 month period. This deeming provision is not in the US or OECD Model Conventions but appears in the UN Model.²⁹⁵ Only the DTAs South Africa concluded with Canada, Croatia, the Czech Republic, Denmark, Finland, India, Ireland, Korea, Malawi, Malta, Namibia, Norway, Thailand, Uganda and Tanzania, Japan, Singapore, the United States, Zambia and Zimbabwe have the 183-day deeming provision.²⁹⁶

The use of the word 'individual' in Article 14 (Independent personal services) of the treaty between South Africa and the United States suggests that this provision does not apply to companies. This is confirmed in the Commentary under Article 14. It should be noted that the definition of a PE in this treaty includes:

'the furnishing of services, including constancy services, within a Contracting State by an enterprise through employees or other personnel engaged by the enterprise for such purposes, but only if activities of that nature continue

²⁹⁵ At a 14(b).

²⁹⁶ Most of these deeming provisions are contained in s 14(1) of the relevant DTAs with the exception of Malawi at a 8(1)(a), Namibia at a 9(1)(a), Uganda and Tanzania at a 13(1)(a), Zambia and Zimbabwe at a 9(1)(b) and Singapore at a 13(1).

*(for the same or a connected project) within that State for a period or periods aggregating more than 183 days in any 12 month period commencing or ending in the taxable year concerned.*²⁹⁷

The fact that services performed by a company for longer than 183 days in either South Africa or the United States is deemed to be a PE, means that for a company performing services there is deemed to be a PE and for an individual performing personal services there is deemed to be a 'fixed base' if it continues for more than 183 days. But it seems clear from the definition that the services of a company must be performed through employees or personnel of the enterprise, which would exclude services performed by a server computer where no employees or personnel of the enterprise are employed, irrespective of the number of days. In the 183 days deeming provisions relating to individuals, Article 14 states that the individual must 'stay' in the State concerned for that number of days. If an individual performs services from a server in one State, he or she would in most cases never have to 'stay' at the same location as the server. It would even be possible for such a individual to update and change his or her server from a foreign location. It is therefore suggested that both deeming provisions require the presence of residents or employees of a resident company of one state at the location where the services are provided, which would not be the case where a server provides the services electronically.

The term '*professional services or other activities of an independent character*' is not defined in the treaty between South Africa and the United States. In the UN Model²⁹⁸ the term is defined to include independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants. The same definition is used in the OECD Model²⁹⁹ and the Commentary thereto states that the enumeration has an explanatory character only and is not exhaustive. It should be noted that the services of artists, like entertainers, could fall under the provisions of other articles in some DTAs.³⁰⁰ Furthermore this provision does not relate to dependent personal services and relationships as between employer and employee, which is dealt with in other provisions and not necessarily relevant to electronic commerce taxation.³⁰¹

The term '*fixed base*' is not defined in any of the Model Conventions. According to the Technical Explanation to the treaty between South Africa and the United States, the meaning of a '*fixed base*' is understood to be similar but not identical to that of a PE. During the 1996 IFA Congress in Geneva the remark was made that a '*fixed base*' and a PE were different phrases, which implied that they should have different

²⁹⁷ At a 5(2)(k).

²⁹⁸ At a 14(2).

²⁹⁹ At a 14(2).

³⁰⁰ Eg a 17 of the RSA/US Treaty deals with the performance income of entertainers.

³⁰¹ One of the characteristics of electronic commerce is that most of the economic activities are done electronically, which limits the use of employees to a great extent.

meanings,³⁰² and that a '*fixed base*' implied a given location, a degree of continuity or permanence and a connection between the activity and the base. The OECD Commentary³⁰³ states that the taxation of '*business profits*' and '*independent personal services*' are based on the same principles, but that the concept of a PE should be reserved for commercial and industrial activities. The reasoning behind this argument is unclear.

The Commentary to the US Model Convention³⁰⁴ concludes that the question whether a '*fixed base*' is regularly available must be determined by the facts and circumstances of each case.

It is therefore suggested that the problems electronic commerce and the use of server computer create in defining a PE, would also apply to a '*fixed base*'. It could be assumed that possible changes to the PE definition would also apply to a '*fixed base*'.

³⁰² Bracewell-Milnes & Jager.

³⁰³ At a 14(4).

³⁰⁴ At a 14.

CHAPTER 7 - CONCLUSION

The information revolution continues to sweep through the world economy at a speed nobody expected. Tax principles and systems of tax administration will have to adapt. Cyberspace is a borderless world and our current views of source and residence will become increasingly vague. Tax legislation and tax courts throughout the world never expected a new and borderless global trade route.

Officials at the South African Revenue Service are aware of the new problems, but for solutions they look at the Legislature. Current rules and principles can simply not provide any answers. Therefore this Paper concentrated on the problems created by electronic commerce. As to possible solutions, the Katz Commission shares the indecisiveness plaguing legislators in this area:

'to seek a pioneering role here, would be both arrogant and dangerous'.

Nevertheless, the author cannot resist the temptation to speculate about the future. In the current chaos, one thing seems clear, and that is that no future tax system would be effective if it is not the product of international consensus. Such a system should be equitable, simple and certain. The system should also be sufficiently flexible and dynamic to ensure that tax rules keep pace with further technological and commercial developments. In this regard the OECD and the UN will play a very important role.

It is suggested that the solution to effectively taxing electronic income would be one of, or a combination, of the following possibilities:

- Existing definitions, concepts and judgements in domestic tax law could be expanded and re-defined to be applicable to electronic commerce;
- Existing domestic legislation and DTAs could be amended to provide for electronic commerce. This could be done in much the same way as the current s 9C in the Act;
- The Legislature could adopt a wait-and-see approach and incorporate international consensus in domestic legislation and DTAs;
- A multilateral super-DTA to regulate the taxation of electronic commerce could be established where every country is a treaty partner; and
- There could be a move away from income tax to indirect taxes, such as a use tax for Internet access. The idea of 'tax toll booths' on the Internet could also be examined.

Personally the author would prefer the idea of a super-DTA to tax income from electronic commerce internationally. This could be done under the auspices of either the OECD and the UN or under the WTO. The only purpose of such a DTA would be to source electronic income to a certain country. It would create international certainty and source income to a specific country according to international rules contained therein. This approach would limit the impact on domestic legislation and fruitless exercises in definition stretching. It could truly be a tax treaty for cyberspace that strikes a balance between the developed and developing world.

In the interim, the current chaos and uncertainty create the climate for limitless tax planning possibilities.

Finally, and borrowing from Michael Karlin, the author hopes that this Paper lifted some of the cosmic fog which seems to settle on the tax community when the Internet is the topic. However, it would take much more than a light legislative breeze to lift this fog permanently. A gale force south-easter seems more appropriate.

'We are on the verge of a revolution that is just as profound as the change in the economy that came with the industrial revolution.

Soon electronic networks will allow people to transcend the barriers of time and distance and take advantage of global markets and business opportunities not even imaginable today, opening up a new world of economic possibilities and progress'

- US Vice President Albert Gore Jr. -

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*'Begin at the beginning', the King said,
very gravely,
'and go on until you come to the end,
then stop'*

**- Lewis Carroll -
Alice in Wonderland**