THE EFFECT OF GLOBAL E-COMMERCE ON TAXATION LEGISLATION AND THE PERMANENT ESTABLISHMENT CONCEPT IN SOUTH AFRICA

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ABSTRACT

The objective of this thesis was to analyse the effect of the increasing popularity of global e-commerce on the South African legislative framework in respect of the taxation of non-resident enterprises, and to propose a possible solution for the taxation of e-commerce, taking into account previous theories. The methodology utilised comprised of a critical analysis of the legal rules relating to the taxation of a foreign entity's business profits by virtue of the application of the permanent establishment principle, its definition and evolution as a conceptual basis for taxation. Furthermore, an in depth evaluation of the various solutions that have already been proposed and, in some cases, implemented was undertaken. It was concluded that the application of the permanent establishment principle is wholly ineffective as a means to levy tax on the e-commerce business profits of a foreign entity as the principle relies too heavily upon a physical intermediary in the source state, whereas e-commerce transactions are conducted on the intangible trading platform of the Internet. In light of the numerous policy proposals advanced over the years, it was concluded that the most feasible and practical solution for the taxation of foreign e-commerce would be the imposition on a foreign entity in South Africa of a low withholding tax on the active business profits in excess of a pre-determined threshold.

Key words: South African taxation; e-commerce; foreign business entity; permanent establishment; withholding tax.

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CHAPTER ONE

INTRODUCTION

1.1 CONTEXT OF THE RESEARCH

It is submitted that the rapid development of global e-commerce is eroding the South African tax base. In a global economy, multi-national enterprises perform their business activities throughout the world, largely through the utilisation of the Internet[1]. Oguttu and Tladi[2] and Stravitz[3] explain that the use of the Internet as a means to do business has provided the world with an environment in which persons are able to conduct significant business enterprises with little or no physical activity.

These business activities carried out by electronic means are collectively known as "e-commerce", which utilises technological advances in the transmission of voice, data, images and video information over the Internet to enable persons to trade without being confined by traditional geographical boundaries.[4]

In the circumstances, transactions in this environment are highly efficient and the almost instantaneous transmission of information and ease of trade from one jurisdiction to another at relatively low costs, coupled with the almost indispensable nature of the Internet as a tool in business, makes e-commerce attractive and lucrative to both the ordinary businessman working from home and global companies alike.[5] Accordingly, a trend has developed towards what is known as a

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[1] Organisation for Economic Co-operation and Development: *Report on Empowering E-consumers* (2009) 6.

[2] AW Oguttu and S Tladi "E-Commerce: A Critique on the Determination of a "Permanent Establishment" for Income Tax Purposes from a South African Perspective" (2009) 20 *Stell LR* 74 at 80,

[3] HB Stravitz "Personal Jurisdiction in Cyberspace: something more is required on the Electronic Stream of Commerce" (1998) *South Carolina Law Review* 925 at 925.

[4] RL Doernberg & L Hinnekens *Electronic Commerce and International Taxation* (1999) 3.

[5] AW Oguttu "The Challenges that E-Commerce Poses to International Tax Laws: 'Controlled Foreign Company Legislation' from a South African Perspective (Part 1)" (2008) 20 *SA Merc LJ* 347 at 349.

"global economy", i.e. one that has broken down the economic barriers between countries and encouraged an increase in international trade.[6]

Despite its appeal to the business world, e-commerce is not without its challenges.[7] The highly mobile nature of e-commerce and the ability of residents to establish and maintain offshore companies from anywhere in the world, may lead to a migration of businesses to low-tax jurisdictions.[8] Furthermore, the anonymous nature of e-commerce creates opportunities for deferring and avoiding tax as a result of the inherent difficulties encountered in the identification and location of taxpayers, the identification and verification of transactions upon which tax may be levied, and the ability to establish a link between taxpayers and such transactions.[9]

Whilst the ability of global computer-based communications to transcend territorial borders at the click of a button broadens the possible target markets of a taxpayer's business, the most far-reaching effect of the creation of an entirely new realm of human activity with no discernible presence is that it undermines the feasibility and legitimacy of laws based on geographical boundaries, as the term "place" has little meaning in such a context.[10] The overall effect of the non-geographical existence of e-commerce is that it makes it exceedingly difficult to establish international norms for identifying the source of a taxpayer's income.

The reason the identification of the source of income is important for South Africa is because of the wording in the current legislative framework governing the taxation of source income in South Africa. In order to tax a person (whether natural or juristic) on any amount, there must be a connection between the country wishing to levy such tax and the amount to be taxed.[11] This connecting factor

[6] See further JJ Fawcett, J Harris and M Bridge *International Sale of Goods in the Conflict of Laws* (2005) 493.
[7] Oguttu 2008 *SA Merc LJ* 350.
[8] DR Johnson and DG Post "Law and Borders: the Rise of Law in Cyberspace" (1996) *Stan L Rev* 1367 at 1370-1371.
[9] KE Thorpe "International Taxation of Electronic Commerce: is the Internet Age rendering the Concept of Permanent Establishment obsolete?" (1997) *Emory International Law Review* 633 at 646-651.
[10] Oguttu and Tladi 2009 *Stell LR* 80.
[11] AP de Koker *Silke on South African Income Tax* (2009) par 5.1.

could be either that the person who derived the income is a resident of the particular state, or that the income originated from a source within the country.[12]

Contrary to the residence based system of taxation, which is generally used by investor countries, a source based system of taxation is generally found in investee countries which are still developing.[13] The rationale behind a source based system of taxation is that persons should contribute to the costs of the infrastructure and the running of the country which has enabled him/her to produce the income in question.[14] Thus in *Kerguelen Sealing & Whaling co Ltd v CIR*[15] if the natural resources of a country or the activities of its inhabitants produce income, the state is entitled to a share of that wealth, regardless of where the recipient of the income may be a resident of that state. In other words, this basis of taxation is justified by the fact that the taxpayer benefits from the country's natural resources and the state services that are provided to those who interact with the country in question.[16]

According to section 1 of the Income Tax Act ("the Act")[17], income tax is only levied on a person's gross income which is defined as, in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident in any year of assessment (i.e. taxation is based on the taxpayer's *residency*), and, in the case of a non-resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person *from a source within or deemed to be within the Republic* (own emphasis) Thus the levying of tax in respect of non-residents is based on the source of the income. In the circumstances, although South Africa generally applies a residence based system of taxation, an element of the source principle has been retained in that non-residents (persons who do not qualify as residents) are taxed on income generated within or deemed to be generated within the country. [18]

[12] L Olivier "Residence based taxation" (2001) 1 *THRHR* 20 at 21.
[13] Olivier 2001 *THRHR* 21.
[14] L Olivier and M Honiball *International Tax – A South African Perspective* (2011) 52.
[15] 1939 AD 487, 10 SATC 363.
[16] Olivier 2001 *THRHR* 21; M Stiglingh *Silke: South African Income Tax 2012* (2011) 55.
[17] Act 58 of 1962.
[18] F Mosupa "Who pays which taxman now?" (2001) 9 *Juta's Business Law* 160 at 160; Olivier 2001 *THRHR* 21.

Notwithstanding the above, the term "source" is not defined in the Act.[19] The courts have, however, established a number of rules or tests for the purpose of determining the source of income and the location thereof which are of particular importance when considering whether the South African Revenue Service is at liberty to tax the income earned by a non-resident multi-national enterprise, in circumstances where such an enterprise performs part of its business activities in South Africa. These tests all centre on the concept of an "originating cause" as discussed in *CIR v Lever Brothers & Unilever Ltd*[20], and include the test where the capital is employed,[21] the activities test[22] and the test where the contract is concluded[23]. There is accordingly a wealth of case law in South Africa to assist in the determination of where a "source" of income may be located. Section 9 of the Act also makes provision for the taxation of certain transactions and provides that the proceeds are from a South African source, therefore overriding existing case law.

Should a multi-national enterprise perform part of its business activities in South Africa in circumstances where tax may be levied by the South African Revenue Service on the business profits, it is not only possible but highly probable that that entity will also be liable for tax on the income in question in its own country of residence, as most developed countries levy tax on a worldwide basis.[24] Accordingly, this will give rise to economic double taxation of the same amount of income.[25]

In an effort to foster international trade and avoid the practical difficulties associated with double taxation, two jurisdictions ordinarily enter into an international agreement, known as a double tax agreement, the provisions of which are incorporated into our law by virtue of section 108 of the Act. The purpose of the double tax agreement is to effectively regulate the way in which the two

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[19] E Mazansky “Change your mindset: the rules of the game have changed” (2001) 15 *Tax Planning* 31 at 31.
[20] 1946 AD 441, 14 SATC 1.
[21] *Rhodesian Metals Ltd v COT* 1938 AD 282, 9 SATC 363.
[22] *CIR v Epstein* 1954 (3) SA 689, 19 SATC 221.
[23] *ITC 81* (1927) 3 SATC 136.
[24] Organisation for Economic Co-operation and Development Discussion Document: *Are the Current Treaty Rules for Taxing Business Profits Appropriate for e-Commerce?* (2007) 7.
[25] *Ibid.*

jurisdictions will share or allocate the right to tax the income of the non-resident multi-national enterprise and is given effect by the stipulation of rules determining in which jurisdiction the income will be taxed.[26]

The terminology often utilised in double tax agreements concluded with South Africa refers to the concept of a "permanent establishment" to allocate a taxing right to a specific jurisdiction.[27] The concept is thus significant in that the existence of a double tax agreement allows the country in which the establishment is situated, i.e. the source country, to tax its income, regardless of the fact that the permanent establishment may not have a separate legal existence as a resident in the Republic.[28]

For example, if a non-resident enterprise is liable to pay tax in South Africa due to the fact that it earned income which was derived from an actual or deemed source in South Africa, a double tax agreement will confirm South Africa's right to tax the profits of such non-resident enterprise, but *only* to the extent that that enterprise carries on its business through a permanent establishment situated in South Africa.[29]

In the words of Shakespeare, "*therein lies the rub"*.[30] The development of the Internet has allowed online retailers to accomplish much of their sales and advertising strategies via a website that allows direct interaction with the customer and transfers such transaction costs to customers, thus eliminating the need for a physical intermediary in the source state.[31] Furthermore, customers may purchase commodities or gain access to services without ever having to leave the comfort of their own homes, which has thus enabled international corporations to centralise many of their operations in one jurisdiction, usually the country in which it is

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[26] AW Oguttu and B van der Merwe "Electronic Commerce: Challenging the Income Tax Base?" (2005) *SA Merc LJ* 305 at 316.
[27] Oguttu and Tladi 2009 *Stell LR* 76.
[28] See Article 5 of the Organisation for Economic Co-operation and Development: *Model Tax Convention on Income and on Capital* (2008).
[29] R Azam "E-Commerce Taxation and Cyberspace Law: The Integrative Adaptive Model" (2007) 12 *Virginia Journal of Law & Technology* 1 at 3.
[30] W Shakespeare *Hamlet* Act 3, Scene 1.
[31] AL Shapiro "Digital Middlemen and the Architecture of Electronic Commerce" (1998) *Ohio North University Law Review* 795 at 795 . Oguttu and van der Merwe 2005 *SA Merc LJ* 305.

registered, despite conducting significant business in a multiplicity of foreign countries.[32] As a result of an international company's ability to shift part of its operations from traditional permanent establishments, as defined, to the Internet and facilitate significant business transactions electronically, it is submitted that there is great potential for the reduction of the amount of income that may be attributable to an international company in a foreign country.

In an effort to address the challenges posed to the traditional permanent establishment principle by the advent of e-commerce, the Organisation for Economic Co-operation and Development ("OECD") has developed certain guidelines which have adapted traditional principles to deal with the current technological climate.[33] Although South Africa is not a member of the OECD and is therefore not bound by its rules and recommendations, section 1 of the Act has defined the permanent establishment concept with reference to the definition thereof in Article 5 of the Organisation for Economic Co-operation and Development Model Tax Convention ("OECD Model Convention"), and as a treaty term, it was opined in *SIR v Downing*[34] that South Africa ought to take the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Convention into account.

It is, however, submitted that these guidelines are impractical and the solution provided only serves as an artificial means of addressing the problems associated with the taxation of e-commerce, whilst ignoring the practical realities.

In light of the above, the question arises as to whether the South African legislative and treaty law framework provides a practical basis for taxing e-commerce. If not, further questions as to the general applicability of the current source rules become relevant and one is compelled to ask whether it is possible and practical to develop the current law to deal with e-commerce, or whether alternative solutions ought to be canvassed.

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[32] Oguttu and Tladi 2009 *Stell LR* 81.
[33] Oguttu and Tladi 2009 *Stell LR* 82.
[34] 1975 (4) SA 518 (A) 524.

1.2. THE GOAL OF THE RESEARCH

In light of the above, the goal of the research undertaken was to analyse the effect of the increasing popularity of global e-commerce on the South African legislative framework in respect of the taxation of non-resident enterprises and to propose a possible solution for the taxation of e-commerce, taking into account how other jurisdictions have attempted to address the challenges posed by e-commerce.

This analysis focused on the difficulties encountered as a result of the growth of e-commerce, the tax rules relating to source, the identification of a permanent establishment for tax purposes and the attribution of business profits to such permanent establishments.

In the circumstances, the research considered whether the extant legislative framework provides an appropriate basis for the development of the rules governing this area of law, or whether an entirely new basis for taxation of such profits ought to be considered.

1.3. METHODS, PROCEDURES AND TECHNIQUES

An interpretative research approach was adopted for the present research which sought to understand and describe.[35] The research methodology applied can be described as a *doctrinal* research methodology. This methodology provided a systematic exposition of the rules governing a particular legal category (in the present case the legal rules relating to the taxation of source income and the impact of e-commerce thereon), analysed the relationships between the rules, explained areas of difficulty and was based purely on documentary data.[36]

The research methodology comprised of a critical analysis of certain documentary data in order to reach a conclusion and propose possible alterations to the existing tax legislation, if and where appropriate. The documentary data considered

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[35] E Babbie and J Mouton *The practice of social research* (2009).

[36] M McKerchar "Philosophical paradigms, inquiry strategies and knowledge claims: applying the principles of research design and conduct to taxation" (2008) *E-Journal of Tax Research* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1464141 (accessed 8 November 2011).

included the applicable South African tax legislation; relevant case law; the persuasive value of the relevant articles of the OECD Model Convention and attendant commentary and reports of the OECD in this regard; and various other articles, reports, and interpreted findings by the South African courts in relation to the underlying tax principles.

The research was conducted in the form of an extended argument, supported by documentary evidence. The validity and reliability of the research and the conclusions have been ensured by an adherence to the rules of legal interpretation, as established by common law; the placing of greater evidential weight on legislation, case law which creates precedent or which is of persuasive value (primary data) and the writings of acknowledged experts in the field; the discussion of opposing viewpoints and conclusions based on a preponderance of credible evidence; and the rigour of the arguments.

As all the data is in the public domain, no ethical considerations arise.

1.4. OVERVIEW OF THE CHAPTERS

Having conducted the requisite research in terms of the methodology outlined above, this thesis seeks to describe the results obtained from such research and the reasoning behind the drawing of certain conclusions and the motivations behind the proposed solution in the South African context.

In order to provide a rich contextual background as to why this research is of importance, the second chapter delves into what e-commerce actually is, its significance in the global trend towards a borderless commercial landscape, and how e-commerce has grown exponentially in recent history to become a common-place trading platform.

The third chapter then deals with the legal principles relating to the jurisdiction in which income can be taxed. In this regard, South Africa's model of taxation being primarily residence based, but with an element of the source principle being retained in that non-residents are taxed on income generated within or deemed to be generated within the country, is thoroughly explored. In light of the conclusions drawn and the solutions discussed later in this thesis, a cursory exposition of the law relating to the apportionment of taxation is also undertaken.

Having satisfactorily contextualised both the factual matrix in which the question outlined above arises, as well as the legal principles relating to the taxation of the income of non-residents, the fourth chapter examines the more specific subject of the taxation of a foreign entity's business profits by virtue of the application of the so-called "permanent establishment principle", its definition and evolution as a conceptual basis for taxation. In bringing together the facts and the law applicable, this chapter then discusses the effect of e-commerce on the permanent establishment principle and the challenges posed by e-commerce to the continued relevance of the permanent establishment principle in this context.

The fifth chapter of this thesis contains the various solutions that have been proposed and, in some cases, implemented in an effort to address the challenges e-commerce poses to the continued applicability of the permanent establishment as an effective means to levy tax on the business profits of a foreign entity. Due to the fact that the OECD Model Convention guidelines[37] are utilised by the majority of countries engaged in e-commerce dealings, a detailed explanation of the proposal contained therein, as well as the relative disadvantages in its application are explored. The tax literature contains a wealth of other policy proposals designed to overcome the challenges posed by e-commerce in this context and therefore, a discussion of the other solutions and recommendations is undertaken.

In light of the context provided, both factual and legal, and having considered the various alternatives proposed by writers over the better part of two decades, the sixth chapter advances a possible solution for the taxation of e-commerce in the form of the imposition of a low withholding tax on the active business profits of a foreign entity in South Africa above a pre-determined threshold.

[37] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2008).

CHAPTER TWO

E-COMMERCE

2.1. INTRODUCTORY REMARKS

The Internet has grown from a complex system that was only accessible to a relatively small minority with the necessary skills to utilise its potential, to an everyday platform for communication, research, recreation, advertising and trading. One of the fundamental assumptions in embarking upon the research undertaken in this thesis was that the popularity of the Internet, and specifically electronic commerce, has grown exponentially. It is therefore necessary to first ascertain whether this growth is of such a magnitude as to warrant concern in respect of the continued applicability of the taxation laws which may be affected by the expansion of electronic commerce. This chapter delves into what "e-commerce" is, its contribution to the creation of a global economy, and the growth of e-commerce as a means to do business, particularly in the context of emerging economies.

2.2. WHAT IS E-COMMERCE?

The Internet as it exists today has provided a powerful tool that enables consumers from all over the world to search for and buy goods and services, regardless of where they and the seller are located.[38] This wide array of commercial activities which may be carried out by electronic means is known as "electronic commerce", or more colloquially, "e-commerce".[39]

E-commerce has been defined as "*commercial activities which are carried on by means of computers interconnected by telecommunications lines... [and] business transactions conducted over the Internet*".[40] The Department of Communications

[38]Organisation for Economic Co-operation and Development: *Report on Empowering E-consumers* (2009) 6.

[39] Oguttu 2008 *SA Merc LJ* 348. See further RL Doernberg, L Hinnekens, W Hellerstein and J Li *Electronic Commerce and Multijurisdictional Taxation* (2001) 3.

[40] Oguttu 2008 *SA Merc LJ* 348. See further Fawcett *et al International Sale of Goods* 493.

in South Africa has further defined the concept in its Green Paper on E-commerce[41] as the "*use of electronic networks to exchange information, products, services and payments for commercial and communication purposes between [individual consumers] and businesses; between businesses themselves; between consumers themselves; within government; or between the public and government*". The Australian Taxation Office[42] has, however, used a much narrower definition and considers e-commerce to consist merely of the "*buying and selling of goods and services on the Internet"*.

However the exact definition of e-commerce may differ from one jurisdiction to another, essentially e-commerce is the utilisation of technological advances in the transmission of voice, data, images and video information over the Internet to enable persons to trade without being confined by traditional geographical boundaries.[43] E-commerce is conducted mainly through global computer networks via the Internet, a platform whose architecture is that of an open, distributed network consisting of a system of packet switching and a universal communications protocol which has ultimately lead to the Internet as we know it – a global "network of networks".[44]

This revolutionary advancement in technology has thus resulted in the development of a trend towards what is known as a "global economy", i.e. one that has broken down the economic barriers between countries and encouraged an increase in international trade.[45] The use and interconnectedness of the Internet has thus provided the world with an environment in which persons are able to conduct significant business enterprises with little or no physical activity.[46] The development of e-commerce has increased consumers' ability to research and compare various products, enhanced the number of choices available to

[41] See further Department of Communications: *Green Paper on E-commerce: making it your Business* (2000) 9; Oguttu and Tladi 2009 *Stell LR* 79 and Thorpe 1997 *Emory International Law Review* 646-651.
[42] Australian Taxation Office Electronic Commerce Project Team "Tax and the Internet – Volume 1" (1997)
http://www.cse.buffalo.edu/DBGROUP/nov6_taxinte.pdf (accessed on 15 March 2012) 12.
[43] See further C Sher "Taxation of E-Commerce" (2000) 39 *Income Tax Reporter* 172 at 172.
[44] D Pinto *E-Commerce and Source-Based Income Taxation* (2003) para 1.1.
[45] Oguttu and van der Merwe 2005 *SA Merc LJ* 305.
[46] Oguttu and Tladi 2009 *Stell LR* 80. See further Stravitz 1998 *South Carolina Law Review* 925.

consumers, including customised products, and the increase in transparency and access to information has intensified competition and lowered prices for the average consumer.[47] Furthermore, transactions in this environment are highly efficient and the almost instantaneous transmission of information and ease of trade from one jurisdiction to another at relatively low costs, coupled with the almost indispensable nature of the Internet as a tool in business, has made e-commerce attractive and lucrative to both the ordinary businessman working from home and global companies alike.[48]

With the increase in popularity of digitised products, an increased number of intangible products and services are marketed and sold online, from software and entertainment products such as gaming and music, to services, including travel and ticketing, banking, insurance and brokerage, information, legal, real estate, health-care, education and government services.[49] The prevalence of credit cards and other programs which allow electronic transfers of money have augmented the growth of e-commerce in that transactions for the purchase of intangible products can be completed entirely over the Internet, where purchase, payment and delivery are all effected using this global "network of networks".[50]

For the sake of completeness and as intimated above, it is noted that e-commerce has three basic forms; business-to-business transactions, business-to-consumer transactions, and consumer-to-consumer transactions.[51] Although business-to-business commerce has been a prominent category for several years, the two consumer-oriented forms of e-commerce have been growing rapidly in recent years due to *inter alia* the rapid expansion and availability of the Internet, an increase in broadband access, the rising number of individuals connected to the Internet, the presence of e-retailers who are Internet-only based (such as Amazon.com), the ease with which websites may be created and the development

[47] Organisation for Economic Co-operation and Development: *Report on Empowering E-consumers* (2009) 7.
[48] Oguttu 2008 *SA Merc LJ* 349.
[49] Pinto *E-Commerce* para 1.1.
[50] *Ibid.*
[51] Organisation for Economic Co-operation and Development: *Report on Empowering E-consumers* (2009) 6.

of mobile commerce.[52] With the increased demand for South Africa to be connected to the first world via fibre optic cables laid under the sea, it is only a matter of time before the consumer-oriented forms of e-commerce become a prevalent means by which ordinary South Africans partake in the global economy.

Despite its appeal to the business world, e-commerce is not without its challenges. The highly mobile nature of e-commerce and the ability of South African residents to establish and maintain offshore companies from anywhere in the world, increases the prevalence of businesses migrating to low-tax jurisdictions.[53] Furthermore, the anonymous nature of e-commerce creates opportunities for deferring and avoiding tax as a result of the inherent difficulties encountered in the identification and location of taxpayers, the identification and verification of transactions upon which tax may be levied, and the ability to establish a link between taxpayers and such transactions.[54] Whilst the ability of global computer-based communications to transcend territorial borders at the click of a button broadens the possible target markets of a business, the most far-reaching effect of the creation of an entirely new realm of human activity with no discernible presence is that it undermines the feasibility and legitimacy of laws based on geographical boundaries, as the term "place" has little meaning in such a context.[55]

In many ways, consumer-oriented e-commerce is very similar to the traditional model of distance selling carried out by mail order whereby buyers and sellers have limited or no personal contact and the two are often not in close proximity to one another.[56] As the Internet is generally considered to have an "*inherently international nature*" and e-commerce transactions take place much more easily and faster than traditional distance selling, the overall effect of the non-geographical existence of e-commerce is that it makes it exceedingly difficult to establish international norms for identifying the source of a taxpayer's income.[57]

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[52] *Ibid*.
[53] Oguttu 2008 *SA Merc LJ* 350. See further R Buys and F Cronje (eds) *Cyberlaw @ SA II: The Law of the Internet in South Africa* 2ed (2004) 301.
[54] Oguttu 2008 *SA Merc LJ* 350.
[55] Oguttu and Tladi 2009 *Stell LR* 80. See further Johnson and Post 1996 *Stan L Rev* 1370-1371.
[56] Organisation for Economic Co-operation and Development: *Report on Empowering E-consumers* (2009) 6.
[57] Oguttu and Tladi 2009 *Stell LR* 80.

In an effort to address the challenges posed by e-commerce, many countries have attempted to apply the laws and regulations applicable to distance selling in the context of e-commerce.[58] The traditional taxation concepts based on geographical boundaries have, as will be elucidated below, proved to be wholly ineffectual in dealing with the extant situation and accordingly, there has been a rise in the development of new guidelines, laws and regulations in an effort to address the new challenges posed in the global commercial environment.[59]

Although the concerns regarding the threat that internet-based businesses pose to various countries' income tax bases appear to have declined in recent years, the issue continues to exist, largely unresolved, and thus it remains necessary to assess the challenges associated with e-commerce. The international community is currently more concerned with the effect of e-commerce on indirect taxes such as Value-Added Tax, however, as the prevalence of e-commerce grows, so does the possible revenue which could be raised through effective taxation methods, and to disregard this potential tax revenue will significantly erode the tax base in the future.

2.3. THE GROWTH OF E-COMMERCE AS A MEANS TO DO BUSINESS

In 2009, the Organisation for Economic Co-operation and Development ("OECD") compiled a report which explored the expansion of e-commerce in the OECD area and found that the number of consumers purchasing goods and services over the Internet rose from 26.9% in 2004, to 35% in 2008, constituting an increase of 8.1% over a four year period.[60] According to American studies undertaken a decade and a half ago, just before the twenty-first century, consumers were not buying many products online and those that did utilise the Internet did so for email and research purposes and, if considering products, only used the Internet as a means by which to compare features, advantages and benefits, after which the actual purchase was

[58]Organisation for Economic Co-operation and Development: *Report on Empowering E-consumers* (2009) 6.
[59]*Ibid.*
[60]Organisation for Economic Co-operation and Development: *Report on Empowering E-consumers* (2009) 7.

then completed employing traditional means.[61] In 2008, however, the Pew Internet and American Life Project survey concluded that 66% of "*online Americans*" purchased a product online in 2007 – an increase of 20% from 2000.[62]

In the European Union, it was concluded that in 2007, out of the 36% of Internet users who compared goods or services on the Internet, 17% purchased a product online, 10% purchased a product in a shop, and 13% did not make a purchase.[63] Accordingly, although such research was limited to the United States of America and the European Union, as these jurisdictions undertake a considerable portion of trade activities globally, it is irrefutable that by as early as 2007, online purchases had already increased quite notably.

More recently, according to the 6th Annual Online Future Shopping Index data compiled by Logan Tod and Co[64], online sales across Europe over the Christmas period in 2011 rose 28% from the previous year, with Germany, Switzerland and Norway seeing the highest online retail market shares. In particular, 26 December 2011 was hailed as the biggest ever online shopping day, with an increase of 19.5% from the previous year.[65] The Chief Executive of Logan Tod and Co attributed the prolific growth in online sales to the emergence of tablets and other "always on" devices, such as mobile phones, that are able to be perpetually connected to the Internet.[66] More specifically, according to the study, 14% of the total respondents indicated they had used an iPad or another tablet device to make their purchases, whilst 15% of respondents indicated they had used a mobile phone for the same purpose.[67]

During January and February 2012, an independent research agency surveyed 19,000 (nineteen) global consumers and 153 (one hundred and fifty three) online

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[61] Organisation for Economic Co-operation and Development: *Report on Empowering E-consumers* (2009) 8.
[62] *Ibid.*
[63] *Ibid*.
[64] Logan Tod & Co "Britons' Love of eCommerce to Flourish, Whilst Tablets Set the Pace in 2012" (2012) www.logantod.com/wp-content/uploads/2012/01/ \LGTChristmans2011SurveyRelease FINAL.pdf (accessed on 20 June 2012).
[65] *Ibid.*
[66] *Ibid.*
[67] *Ibid.*

merchants from a wide geographic spread, ensuring that the major e-commerce markets were adequately represented. Unfortunately, South Africa did not feature in the study, but many countries from the developed and developing world were represented.[68] Of the 19,000 (nineteen thousand) respondents, 2,000 (two thousand) consumers from each of China, the United States of America, Brazil and India, and 1,000 (one thousand) consumers from each of Germany, Spain, Finland, France, Japan, Russia, the United Kingdom, Mexico, Australia, Canada and Argentina were drawn.[69]

The study found that, on average, 22% of the respondents' annual expenditure on goods and services was typically spent online, with the figure rising considerably above the average in the fast-growth emerging economies of India, Brazil and China – the respondents in these jurisdictions noted that almost a third of their annual outgoings were customarily spent online.[70] More specifically, the study revealed that the average online spend on goods and services in India, Brazil and China constituted 36%, 27% and 31% respectively of the respondents' disposable income.[71]

In respect of international cross-border purchases, the study found that 44% of global online shoppers who partook in the study bought from overseas retailers, with Australia having the highest proportion of 76% of their annual outgoings being spent outside of their borders. In the emerging market, 56% of the respondents from India, 43% of the respondents from Brazil and 44% of the respondents from China stated that they shop on foreign websites.[72] In other words, an average of 48% of the online sales in the fast-growth emerging economies can be attributed to purchases from websites operated from foreign jurisdictions.

Unfortunately, comprehensive data on the magnitude of e-commerce trade are not available for many countries, South Africa being one of these countries, and where

[68] WorldPay "Global Online Shopper Report" (2012) http://www.worldpay.com/globalshopper/report-shopper.pdf (accessed on 20 June 2012) 3.
[69] *Ibid.*
[70] WorldPay "Global Online Shopper Report" 4.
[71] WorldPay "Global Online Shopper Report" 44, 32, 36 respectively.
[72] *Ibid.*

such data do exist, it is not in a format allowing direct comparison.[73] The considerable variations between countries as to the usage of the Internet and concomitant prevalence of e-commerce further contributes to the difficulties in obtaining definitive information in respect of global trends regarding e-commerce.

The above studies, the results of which are in respect of the developed world and *specific* fast-growth economies, ought to be viewed in this context. Notwithstanding this, South Africa has become a more crucial player in the international arena and, following its inclusion in the BRICS association of leading emerging economies (along with Brazil, Russia, India and China) in 2010, one may infer that the results of these studies, especially the results in respect of the other BRICS countries, are indicative of the direction in which South Africa is moving.

What is undeniable, however, is that the popularity of e-commerce is growing. Perhaps the most accurate conclusion is provided by Doernberg *et al*[74] who have surmised the growth of e-commerce by simply stating the obvious: "*[e]lectronic commerce is here; it is growing; and it poses new questions for all aspects of society*".

2.4. CONCLUSION

The commercial activities that are carried on through the use of technology, also known as "e-commerce", have become commonplace in modern society. As the acceptance of the Internet as a trading platform grows, so has the propensity for businesses to move some or all of their business activities to the intangible electronic arena. With fast-growth economies conducting online trade activities well above the global average and cross-border transactions being commonplace in modern society, the crucial question then arises as to which jurisdiction has the right to tax the profits generated by the business conducted.

[73] Organisation for Economic Co-operation and Development: *Report on Empowering E-consumers* (2009) 8.
[74] Doernberg *et al Electronic Commerce and Multijurisdictional Taxation* 2.

CHAPTER THREE

THE JURISDICTION TO TAX

3.1. INTRODUCTORY REMARKS

Having provided the contextual background as to what e-commerce is, its significance in light of the global trend towards a borderless commercial landscape and the exponential growth of the popularity of e-commerce as a trading platform, it is necessary to consider the general legal framework in which e-commerce exists. This chapter considers the legal principles relating to the jurisdiction in which income can be taxed. In this regard, South Africa's model of taxation being primarily residence based, but with an element of the source principle being retained in that non-residents are taxed on income generated within or deemed to be generated from a source within the country, is thoroughly explored. For the sake of completeness, a cursory exposition of the law relating to the apportionment of taxation is also undertaken.

3.2. MODELS OF TAXATION

In order to tax a person (whether natural or juristic) on any amount, there must be a connection between the country that wants to levy such tax and the amount to be taxed.[75] This connecting factor could be either that the person who derived the income is a resident of the particular state, or that the income originated from a source within the country.[76] Accordingly, there are two models of taxation which have been formulated and are used around the world, namely residence based taxation, based upon the former connecting factor, and source based taxation, based upon the latter.[77]

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[75] de Koker *Silke on South African Income Tax* para 5.1.
[76] Olivier 2001 *THRHR* 21.
[77] Oguttu and Tladi 2009 *Stell LR* 74.

The rationale behind a residence based system of taxation is that a resident of a country enjoys the protection of the state in which he lives, and should therefore contribute towards the cost of the government of the country in which he resides, regardless of where the income is earned. [78]

Contrary to the residence based system of taxation, which is generally used by investor countries, a source based system of taxation is generally found in investee countries which are still developing.[79] The rationale behind a source based system of taxation is that persons should contribute to the costs of the infrastructure and the running of the country which has enabled the taxpayer to produce the income in question.[80] Thus if the natural resources of a country or the activities of its inhabitants produce income, the state is entitled to a share of that wealth, regardless of whether the recipient of the income may be a resident of that state. [81] In other words, this basis of taxation is justified by the fact that the taxpayer benefits from the country's natural resources and the state services that are provided to those who interact with the country in question.[82]

In the past, South Africa adopted a source based system of taxation[83], however, with the relaxation of Exchange Control Regulations, South Africa and its inhabitants started becoming bigger players in the international commercial sphere.[84] Due to South Africa's increasing involvement in international business transactions and the fiscal implications thereof, the source based system that was utilised in the past became impractical. [85]

As a result of the ineffectuality of the continued use of the source based system in the changing global economic climate, since 1 January 2001[86] South Africa has applied a residence based system of taxation in terms of which all residents of the

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[78] Olivier 2001 *THRHR* 21.
[79] *Ibid*.
[80] Oliver and Honiball *International Tax: A South African Perspective* 52.
[81] *Kerguelen Sealing & Whaling Co Ltd v CIR*.
[82] Oliver and Honiball *International Tax: A South African Perspective* 52.
[83] M Stein "Living in South Africa: a costly luxury?" (2001) 15 *Tax Planning* 18 at 19.
[84] Olivier 2001 *THRHR* 21-22.
[85] Mosupa 2001 *Juta's Business Law* 160.
[86] The residence based system of taxation was in operation for years of assessment commencing 1 January 2001, however, it is noted that this meant that individual taxpayers were only taxed on their world-wide income as from 1 March 2001.

country are taxed on their worldwide income.[87] This move to a residence based system significantly broadened the South African tax base and sought to ensure that the tax base is protected from exploitation through limiting opportunities for tax arbitrage.[88] South Africa's move to a tax system based on residency has thus assisted in reducing the erosion of the tax base through the use of tax haven countries or countries with substantially lower tax rates than South Africa, and has brought our tax system into line with the generally accepted norms of international taxation.[89] The imposition of the residence based system has thus cast the tax net much wider than was previously the case.[90]

This being said, it is unusual for a country to apply either of the two tax systems previously discussed in a pure form, and South Africa is no different. Although South Africa generally applies a residence based system of taxation, an element of the source principle has been retained in that non-residents (i.e. persons who do not qualify as residents) are taxed on income generated within or deemed to be generated within the country.[91]

Accordingly, persons who are considered to be residents of South Africa for tax purposes are taxed on their worldwide income, whilst non-residents are only taxed on their South African-sourced income, subject to certain exceptions.[92]

For the purposes of this thesis, it is unnecessary to go into more detail regarding the residence based tax system and thus a more in-depth discussion of the source based tax system which applies to non-residents will now be presented.

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[87] De Koker *Silke* 2009 para 5.1. Note that when referring to 'South Africa', the definition in section 1 of the Act of the term 'Republic' must be kept in mind, which in addition to the nine provinces, includes the territorial sea and any designated area outside the territorial sea of the country, as well as areas within which South Africa may exercise sovereign rights or jurisdiction with regard to the exploration or exploitation of natural resources.

[88] De Koker *Silke* 2009 para 5.1.

[89] *Ibid*.

[90] Olivier 2001 *THRHR* 26.

[91] Olivier 2001*THRHR* 21.

[92] Mosupa 2001 *Juta's Business Law* 160; De Koker *Silke* para 5.1. See further Mazansky 2001 *Tax Planning* 31.

3.3. SOURCE OF INCOME

If they are considered to be non-resident in South Africa, taxpayers will only be liable for South African-sourced income, which includes income that has its true source in the Republic, and income that is deemed to be from a South African source.[93] The rationale behind this method of taxation is that all persons who utilise the natural resources of South Africa to earn income should contribute to the costs of the infrastructure and the running of the country that enabled them to produce such income. [94] Accordingly, the country is entitled to a share of that wealth, regardless of where the recipient of the income may be resident. [95]

Although an integral concept, the Income Tax Act ("the Act")[96] does not define the term 'source', as it is not feasible to furnish a universal test that satisfactorily defines all the qualities that determine the source of income.[97] Therefore the source of income received is a question of fact to be determined by the courts in each case.[98] Although the decisions in previous cases give an indication of the kinds of tests and factors that should be considered,[99] the determination of the actual source of income is a "practical hard matter of fact" [100] and thus no one test or factor can be considered to be universally operative.

The court in *CIR v Lever Brothers* held that the word 'source' is used figuratively and could infer either the originating cause of the receipt, or the area from which it is received.[101] On the basis of several previous decisions, Watermeyer CJ concluded that the source of a receipt is not the quarter from which it was received, but the originating cause of the amount being received,[102] i.e. the *quid pro quo* given or work done by the taxpayer in order to receive the amount. Accordingly,

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93 Stiglingh *Silke* 2011 55.
94 Oliver and Honiball *International Tax: A South African Perspective* 52.
95 *Kerguelen Sealing & Whaling Co Ltd v CIR*.
96 Act 58 of 1962.
97 *CIR v Lever Brothers & Unilever Ltd* 13.
98 *CIR v Epstein* 231.
99 *CIR v Black* 1957 (3) SA 536, 21 SATC 226 234.
100 *Rhodesia Metals Ltd v COT* 379 quoting Isaacs J in the Australian case of *Nathan v Federal Commissioner of Taxes* 25 CLR 183; *Rhodesian Metals Ltd (in liquidation) v COT* 1940 AD 432, 11 SATC 244 249; *CIR v Lever Brothers* 13.
101 *CIR v Lever Brothers* 8.
102 *CIR v Lever Brothers* 9.

the term 'source' has been held to allude to the origin of the income, and not just the location thereof.[103] This being said, it must be kept in mind that the originating cause must not be too remote, otherwise it cannot be said to have properly given rise to the income.[104]

In *CIR v Black* the court phrased it slightly differently and held that the source of income is determined by the place where the "*dominant, or main or substantial or real and basic cause*" of the income is situated.[105] In this case, the dominant cause of the income was located in South Africa and therefore the income was from a South African source.[106]

Accordingly, in establishing the source of a particular receipt, an inquiry into two matters must be undertaken. Firstly, a determination of the originating cause of the income must be made, and secondly, the location of that originating cause must be ascertained.[107]

How to actually determine the originating cause of income, however, has been the subject of much debate. The courts have held that there may be a number of causal factors relevant to the ascertainment of source and thus it is necessary to weigh these factors against each other to determine the dominant, main, substantial or real and basic cause of the receipt.[108]

In order to come to such a conclusion, the courts have formulated three different tests to assist in the determination of the source of income.[109] Although these decisions give an indication of the kinds of tests and factors that should be considered,[110] it must be reiterated that the determination of the actual source of

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[103] *Overseas Trust Corporation v CIR* 1926 AD 445, 2 SATC 71 76.
[104] See further *Tuck v CIR* 1988 (3) SA 819 (A), 50 SATC 99 and *ITC 941* (1960), 24 SATC 440.
[105] *CIR v Black* 234.
[106] *Ibid.*
[107] *CIR v Lever Brothers* 8-9; *ITC 1491* (1990), 53 SATC 115 122.
[108] *Essential Sterolin Products (Pty) Ltd v CIR* (1993), 55 SATC 357 366.
[109] Note that other tests have been employed, such as the test of 'where the profits come home to the taxpayer' as formulated and used in the English cases of *Sulley v A.G* 157 ER 1364 and *Grainger v Gough* 1896 AC 325.
[110] *CIR v Black* 234.

income is a "practical hard matter of fact" and the courts must give effect to what the practical man would regard as the real source of the receipt or accrual.[111]

The three tests formulated by the courts are (1) the place where the capital is employed; (2) the activities test; and (3) the place where the contract is concluded. In the context of the research, these tests are significant in that the theories developed to address the challenges raised by e-commerce originate from the utilisation of these concepts. How each test is applied in the e-commerce context is discussed in turn.

3.3.1. TEST 1: THE PLACE WHERE THE CAPITAL IS EMPLOYED

The place where the capital is employed is that location in which the capital of the taxpayer is used to produce an income. According to this test, a foreign company could have its headquarters and place of effective management outside South Africa, but if it employs its capital in the Republic and receives an income due to that utilisation, the source of the income will be considered to be South African. This is because the company has either made use of the South African market to derive the income, or the company has utilised the natural resources of the country to derive the income.[112]

This concept was elucidated in the case of *Rhodesian Metals v COT*, where the court held that the place where the capital is employed, and not the location of the 'brain' of the company, was instrumental in producing the income.[113] In this case the appellant argued that certain income was not derived from a source in Southern Rhodesia, but from London.[114] The reason for this contention was that even though the asset was situated in Rhodesia, both the buying and selling companies were resident in London and the contract was carried out in England.[115]

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[111] *Rhodesian Metals Ltd v* 379; *Rhodesian Metals Ltd (in liquidation) v COT* 249; *CIR v Lever Brothers* 13.

[112] Note that this test can also be applied to natural persons, as was the finding in *Millin v CIR* 1928 AD 207, 3 SATC 170 in which the court held that a man's wits and labour are his capital and income is derived where that capital is employed.

[113] *Rhodesian Metals v COT* 370.

[114] *Rhodesian Metals v COT* 369.

[115] *Rhodesian Metals v COT* 364.

This contention was rejected and the court held that even though certain activities were carried out in London, these transactions were not the real cause of the profit made.[116] The court held that the true origin of the profit was the value of the claims situated in Rhodesia – it was the employment of the company's capital in buying these claims at a low price in Southern Rhodesia that ultimately resulted in the profit earned.[117]

In *COT v William Dunn and Company Ltd*[118], the respondent company was registered in England and carried on business in London, but had three partnership agreements with firms in South Africa.[119] Each partnership agreement contained a buying agreement, in terms of which the company purchased goods in England in its own name, and invoiced and shipped these goods to the South African firm that gave the order.[120] The South African firms were therefore continually indebted to the company, and the company charged interest at 5 per cent per annum on any balance due to it.[121] The South African Commissioner then sought to include this interest in his assessment of the company for that year on the basis that it was derived from a source within the country.[122] The court held that the interest was not received from a source within South Africa, but was the result of the company employing English capital in the carrying on of an English business for the purchase of goods in England.[123] It was this employment of capital in England that gave rise to the interest earned, irrespective of the fact that the debtor firms were situated in South Africa.[124]

The court in *Overseas Trust Corporation v CIR* also applied this test. In this case, the appellant company sold certain shares through brokers in Germany, which also resulted in a profit.[125] Due to the fact that the company was registered and had its principal office in Cape Town, the German brokers were instructed from Cape

[116] *Rhodesian Metals v COT* 376.
[117] *Ibid.*
[118] 1918 AD 607, 32 SATC 33.
[119] *COT v William Dunn* 33.
[120] *Ibid.*
[121] *Ibid.*
[122] *Ibid.*
[123] *COT v William Dunn* 36.
[124] *Ibid.*
[125] *Overseas Trust v CIR* 71.

Town, and the resultant sales were concluded in Cape Town, the Commissioner sought to include the amounts realised in the company's gross income.[126] The court held that the business which produced the profit was the purchase of the shares in Cape Town and therefore the capital employed in this transaction had been employed in the Republic.[127] The fact that the company had an office in Windhoek was considered to be irrelevant in these circumstances because no business operations were carried on there.[128] Accordingly, the court held that due to the fact that the capital was productively employed in South Africa, the profit derived from these transactions was of a South African source.[129]

Within the context of e-commerce, this test is significant in that it presupposes that when a foreign company utilises its capital in South Africa, notwithstanding the fact that the company may not have a physical presence within the Republic, the business produces profit through its investment within the country's borders. Any theory that is based upon this test therefore pays homage to the fact that a foreign company investing resources in and therefore producing a profit as a result of the utilisation of such resources in South Africa, is benefiting from the commercial economy fostered in the Republic and therefore ought to compensate the revenue authorities for the provision of a market that enables the production of this income.

3.3.2. TEST 2: THE ACTIVITIES TEST

The second test which the courts have utilised is the so-called "activities test". In terms of this test, the source of the income is that place in which the activities in producing the income were undertaken.

This was the test utilised by the court in *CIR v Epstein* in which the taxpayer entered into an agreement with a partnership carrying on business in Argentina, in terms of which the taxpayer undertook to purchase asbestos in South Africa which the partnership would then sell in Argentina.[130] The court held that, although the

[126] *Overseas Trust v CIR* 72.
[127] *Overseas Trust v CIR* 76-77.
[128] *Overseas Trust v CIR* 79.
[129] *Ibid.*
[130] *CIR v Epstein* 226-227.

partnership business was carried out in Argentina, the taxpayer did all of his work in South Africa.[131] Therefore the activities that gave rise to the income of the taxpayer (i.e. the work and services he personally rendered) were conducted within the country and the profits derived from these activities were held to have been received by him from a source within South Africa.[132]

Six years later, the court in *ITC 941* again used the activities test as a means of determining the source of a particular income. The taxpayer company carried on business as a general dealer in South Africa.[133] During 1941, at the instance of the Japanese Government, certain goods purchased by the taxpayer were seized at Kobe while in transit to South Africa.[134] After negotiations, the taxpayer paid the drafts that were drawn on it and, after the conclusion of the Treaty of Peace with Japan in 1953, received compensation from the Japanese Government.[135] The Commissioner included this amount in the taxpayer's income on the basis that the original purchase of the goods was for the purpose of the taxpayer's trading activities in the country.[136] The court held that the originating cause of the receipt was the work or activity which the taxpayer expended as the *quid pro quo* in return for which he received the money.[137] Because the taxpayer traded in South Africa alone, the court held that the source of the income was located in South Africa.[138]

Although the court in this instance applied the activities test, it is submitted that the trading activity of the taxpayer which gave rise to the original purchase of the goods was merely a *causa sine qua non* and not the originating cause of the receipt.[139] It is submitted that the wrongful seizure of the goods by the Japanese Government constituted an intervening factor, and therefore it is the seizure in Kobe that constituted the true originating cause of the receipt.[140] Therefore, the activities test is not without fault and a pure application of this test does not cater

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131 *CIR v Epstein* 232.
132 *Ibid.*
133 *ITC 941* 441
134 *Ibid.*
135 *ITC 941* 440.
136 *ITC 941* 443.
137 *Ibid.*
138 *Ibid.*
139 *ITC 941* 442.
140 *Ibid.* In this regard the taxpayer relied on the case of *ITC 560* (1944), 13 SATC 308.

for every possible eventuality as the activities could, in fact, be too far removed from the resultant profit to properly be said to be the originating cause.[141]

Despite this criticism, the activities test was again used some years later in *ITC 1491* in which the taxpayer received overseas franchise fees which the Commissioner sought to include in the taxpayer's South African gross income.[142] The court noted that in this instance, the income was received for the use of incorporeal property (i.e. the right to use a trademark and secret processes) as the taxpayer carried on the business of granting temporary franchises against payment of a sum of money and had established offices in London.[143] Regarding the income derived by the London office, the court applied the activities test and held that the originating cause of this profit was the personal activities of the taxpayer in England in granting the use of the incorporeal property.[144] Therefore the income was held to be from a source outside of the Republic, and accordingly the Commissioner could not include this amount in the taxpayer's gross income.[145]

In the more recent case of *Essential Sterolin Products v CIR* the court had to consider a complex business arrangement in which the taxpayer developed a medicine in South Africa to treat *prostate hypertrophy*.[146] In summation, the taxpayer had registered the product in West Germany and sent the active ingredient to a Swiss company who the marketed the product and sold it to a West German distributor at a profit.[147] A wholly-owned subsidiary of the Swiss company was later registered in West Germany to introduce a generic medicine with the same active ingredient, and a year later the taxpayer incorporated an additional company in the Netherlands Antilles to hold the patents registered in the taxpayer's name.[148] This company thereafter established a number of wholly-owned subsidiaries in Europe and America to develop markets outside West Germany.[149]

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141 I.e. the remoteness problem.
142 *ITC 1491* 118.
143 *ITC 1491* 127-8.
144 *Ibid.*
145 *Ibid.*
146 *Essential Sterolin v CIR* 360.
147 *Ibid.* Initially the active ingredient was sent to West Germany, however, this arrangement had been altered over the course of time.
148 *Essential Sterolin v CIR* 362.
149 *Ibid.*

Pursuant to business discussions, a Sale and Manufacturing Agreement was then entered into between the taxpayer and the distributor in West Germany.[150] One of the clauses in this agreement provided that if the Swiss company, through the inability of the appellant to supply the active ingredient to it, should be unable to supply the ingredient to the West German distributor, the latter would be granted a sublicense to manufacture the substance itself for supply to the Swiss company.[151] An amount of DM 4 000 000 was paid to the taxpayer in terms of the inability agreement, which the Commissioner sought to include in the taxpayer's gross income in terms of para (g)(iii) of the definition of gross income in section 1 of the Act as being a premium or like consideration for the use or the right to use a process. The taxpayer objected to this inclusion on the grounds that the income was not derived from a source within or deemed to be within the Republic.[152]

Upon a consideration of the factual matrix underlying and giving rise to the agreement, the court held that the business operations from which the income was derived were conducted predominantly outside the Republic (i.e. the majority of the activities were conducted outside of the country).[153] Furthermore, the registration, holding of the patent and trade mark rights and the marketing of the product were all done outside of South Africa.[154] In fact, the only causal link to the Republic (apart from the taxpayer being located in the country) was the manufacture of the active substance.[155] Even then, the product could not be marketed in the form it was exported as the activities in South Africa merely constituted the first step in a process of manufacture.[156] The court held that the business of the taxpayer was conducted in Europe and the inability consideration was part of a reorganisation of this business.[157] Accordingly, the originating cause of the receipt was not from a South African source.[158]

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[150] *Ibid.*
[151] The so-called "inability agreement". *Ibid.*
[152] *Essential Sterolin v CIR* 364.
[153] *Essential Sterolin v CIR* 366.
[154] *Essential Sterolin v CIR* 367.
[155] *Ibid.*
[156] *Ibid.*
[157] *Ibid.*
[158] *Ibid.*

The activities test, like the test of where the capital is employed, provides a link between profit earned by a foreign company in South Africa and the Republic itself. The application of this test in the context of e-commerce would entail that the revenue authorities consider where the activities of the company took place, i.e. where the foreign entity marketed its product, conducted significant business operations, accepted payment and delivered its goods. Accordingly, even if the foreign company does not have a branch in South Africa, application of the activities test provides that the source of the income generated will be in South Africa if the activities in producing the income were undertaken within the Republic.

3.3.3. TEST 3: THE PLACE WHERE THE CONTRACT IS CONCLUDED

In terms of South African law, when commercial contracts are entered into, the contract often provides that it is the law governing the place where the contract was concluded that will prevail, should a dispute regarding the contract arise. The third test that has been utilised by our courts to determine the source of an income for tax purposes is based on the premise that since the law often applicable to such a contract is the law of the place in which the contract was concluded, that same government which makes and enforces those laws should be able to tax the proceeds of the contract.

This test was alluded to in the minority judgment of *Rhodesian Metals v COT*, where De Villiers JA departed from the majority and held that the place where the contract of sale was concluded was a decisive factor in the determination of the source of the profit.[159] De Villiers contended that the employment of the capital in this type of case plays a minor role and therefore where the contract forms the essence of the business, and thus the essence of the profit derived, the place where the transaction was entered into is not merely a factor, but rather the true test in determining the source of the income derived.[160]

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[159] *Rhodesian Metals v COT* 379.
[160] *Ibid.*

In *ITC 81* the court considered the possibility of the contract being the determining factor of source. [161] In this case the taxpayer company was registered and had its offices within South Africa, but conducted its business operation wholly outside the country.[162] The taxpayer had chartered a ship to convey the company's produce to Europe, but the ship was not required immediately so the company made use of her to fulfil another contract which had been entered into in Europe.[163] During the same year of assessment, the ship was lost at sea and, in terms of an insurance contract entered into in South Africa, the value of the lost produce was paid out to the company.[164]

When considering the source of the insurance payout, the court noted the remarks in *Lovell and Christmas v COT*[165] that if the essence of the business of the taxpayer is the contract entered into, then the place where the contract is concluded will determine the locality of the source.[166] On the facts, the essence of the taxpayer's *ordinary* business was not the making of contracts as the making of contracts was merely incidental to the main business.[167] However, the insurance was regarded as part of the taxpayer's business and the premiums paid were deducted as expenditure incurred in the production of income.[168]

Therefore the contract was a business operation of the company (although not the primary business) and the essence of this particular business operation was the contract which gave rise to the income.[169] In conclusion, the court held that the income resulting from the contract (i.e. the insurance payout) was derived from a source within South Africa.[170]

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161 *ITC 81* 141.
162 *ITC 81* 136.
163 *ITC 81* 140.
164 *Ibid.*
165 1908 AC 46, quoting *Mount Morgan G.M. Co. v Commissioner of Income Tax* 33 Commonwealth LR 76.
166 *ITC 81* 138. See further *Maclaine v Eccott* 1926 AC 424.
167 *ITC 81* 140.
168 *Ibid.* Note that this was also the court's basis for concluding that the receipt was revenue in nature.
169 *ITC 81* 141.
170 *Ibid.* See further *ITC 3* (1923) 1 SATC 50.

Another case in which the court considered the contract as a factor in determining the source of income was *ITC 432*[171]*.* In this case, the taxpayer company was incorporated in England as a subsidiary to another British company, but carried on business in South Africa.[172] During the tax year in question, the company tendered for and was awarded a contract for the supply and erection of a lift in Rhodesia.[173] As the South African company did not manufacture lifts or maintain a stock of lifts there, the machinery was supplied directly by the holding company in England, and the South African company supplied the technical experts to supervise the erection of the lift.[174] The Commissioner then wanted to include the proceeds resulting from this contract in the taxpayer's gross income.

The court held that the tender was offered in the Republic but only accepted in Rhodesia, therefore the location of where the contract was concluded was where acceptance took place, i.e. Rhodesia.[175] This being said, the court held that the contract was not the true essence of the business, as the profits were also derived from the supply of the lift and the work entailed in its installation.[176] On the facts, however, all these activities took place in Rhodesia and therefore the source of the income was outside the Union.[177]

Although the court in *ITC 432* did not strictly apply the test of where the contract was entered into, it is an important case as it shows that the courts are willing to consider all avenues and tests available to it to determine the source of an income.

The application of this test in the context of e-commerce is of significant importance as transactions are most often concluded on the Internet when the customer orders the goods, thus accepting the offer made by the e-commerce business. Accordingly, the parties reach consensus at the time the customer accepts such an offer and makes the order. This would mean that the agreement is concluded at the place where the customer is situated, notwithstanding the fact

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171 (1939), 10 SATC 437.
172 *ITC 432* 437.
173 *ITC 432* 438.
174 *Ibid.*
175 *ITC 432* 440.
176 *ITC 432* 442.
177 *ITC 432* 443.

that the e-commerce business may be located in another country. Theories based on this premise are therefore strongly in favour of a consumer-based taxation philosophy.

3.4. APPORTIONMENT

South African courts have long been faced with the issue of apportionment of source. In *ITC 77*[178] the Commissioner included income from fees received by the taxpayer as the chairman of a company in his gross income, as well as additional remuneration voted in respect of special services rendered outside of his ordinary duties as chairman.[179] The taxpayer contended that the chairmanship fees should be apportioned on the basis of the time spent in South Africa and the United Kingdom.[180] The court, however, declined to do so and decided the case on the basis of the traditional dominant source doctrine.[181]

This case illustrates that the courts are reluctant to apportion source, primarily due to the fact that there is no provision for the apportionment of source in the Act.[182] This being said, Watermeyer CJ recognised the problem of multiple sources in *CIR v Lever Brothers* and made an *obiter* remark that circumstances may arise in which the "whole of a receipt, or part of it, or none of it is taxable as income from a source within the Union".[183]

These remarks by Watermeyer CJ, although not binding, were considered in the case of *Transvaal Associated Hide and Skin Merchants v COT*[184]. In this case the taxpayer was incorporated in the Republic and carried on the business of buying and selling hides, skins and other by-products of livestock.[185] Certain of these articles were purchased from abattoirs in Botswana where the animals were

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[178] (1927), 3 SATC 72. Note that a year earlier, the court in *Overseas Trust v CIR* also declined the taxpayer's request for apportionment.
[179] *ITC 77* 72.
[180] *Ibid.*
[181] *ITC 77* 75.
[182] *CIR v Black* 234.
[183] *CIR v Lever Brothers* 10.
[184] (1967) 29 SATC 97.
[185] *Transvaal Hide and Skin Merchants v COT* 99.

slaughtered and the hides cured.[186] Upon the facts, the main business was carried on, the contracts were concluded and the hides were rehydrated in South Africa.[187] However, the Collector of Income Tax in Botswana wished to include the income received by the taxpayer from these activities in the taxpayer's gross income in Botswana. The reason for this was that some of the business and the main activity of slaughtering and curing the hides took place in Botswana.[188] Accordingly, the originating cause of the income could have been either South Africa or Botswana as the income had multiple sources.

The majority of the court held that the processes carried out in Botswana were the dominant factors in producing the income in question and therefore the source of the income was Botswana.[189] In his dissenting judgment, Roper P made reference to the *obiter* remark of Watermeyer CJ regarding the possibility of multiple sources of income.[190] It is noted that this possibility has also been referred to by Lord Atkin in the Privy Council appeal in *Rhodesian Metals v COT*[191] and discussed by Schreiner JA in *CIR v Epstein*.[192]

However, the court in *Transvaal Hide and Skin Merchants v COT* (Roper P included) was not prepared to apportion the source because the income tax legislation in Botswana, which is almost identical to the South African Act in respect of source, does not provide for the apportionment of source.[193] Accordingly, the court's decision turned on the determination of the dominant cause.[194]

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[186] *Ibid.*
[187] *Ibid.*
[188] *Ibid.*
[189] *Transvaal Hide and Skin Merchants v COT* 109.
[190] *Transvaal Hide and Skin Merchants v COT* 103.
[191] *Rhodesian Metals v COT* 436.
[192] *CIR v Epstein* 234. Note, however, that in this case, Schreiner JA only considered the possibility of apportionment, but on the facts held that in the absence of any statutory guide, it would be an unworkable option in the circumstances present in that case.
[193] *Transvaal Hide and Skin Merchants v COT* 103.
[194] *Ibid*. It is noted that the reason for Roper P's dissenting judgment was merely a different determination of the dominant source of the income.

Despite the reluctance to apportion source in South Africa and Botswana, the Rhodesian court has been less averse to the idea. In *ITC 1104* [195] the taxpayer carried on business as a commercial diver.[196] In the year of assessment under consideration, the taxpayer had done substantial work in carrying out diving operations in the bed of the Zambezi River below the wall of the Kariba Dam.[197] This involved him working in the river bed on both sides of the boundary line between Rhodesia and Zambia.[198] The Commissioner sought to include the profits derived from this work in the taxpayer's Rhodesian gross income on the basis that the contracts were entered into and his place of business was in Rhodesia.[199] The court held that it was possible in this instance to apportion the source of the income based on the amount of time spent on either side of the boundary line.[200] It must be noted, however, that the reason for apportionment being ordered in this case was because the time occupied in each country and the value of the work done was not in dispute.[201] If the basis of apportionment was contested, the court may not have been so ready to arrive at the same conclusion.

For the sake of completeness, it is noted that the courts are not resolutely loath to consider the possibility of apportionment in general. In fact, notwithstanding the absence of a specific statutory provision, the courts have applied the principle of apportionment to other provisions of the Act such as the apportionment of expenses,[202] the apportionment of the purchase price of shares[203] and the apportionment of one receipt into revenue and capital elements.[204]

In summation, the courts have not yet embraced the idea of apportioning source, however, the acceptance of apportionment in other courts and the emerging trend of applying this principle to other aspects of the Act bodes well for the view that the courts may be more inclined to accept apportionment of source in the future.

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195 (1967), 29 SATC 46.
196 *ITC 1104* 47.
197 *Ibid.*
198 *Ibid.*
199 *Ibid.*
200 *ITC 1104* 49.
201 *Ibid.*
202 *SIR v Guardian Assurance Holdings (SA) Ltd* (1976) 38 SATC 111.
203 *CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A), 45 SATC 241.
204 *Tuck v CIR.*

The concept of apportionment has, however, been utilised in double tax agreements concluded between South Africa and other jurisdictions, as a means to allocate a portion of certain business profits to each jurisdiction in certain circumstances in which the business activities of a foreign enterprise giving rise to such profit have been conducted partially in South Africa and partially in another state.

For example, Article 7.1 of the double tax agreement concluded between South Africa and the United States of America[205] provides that the profits of an enterprise of one of the contracting states will be taxable only in the country of that enterprise unless the enterprise carries on business in the other contracting state through a permanent establishment situated therein. In such a case, the profits of the enterprise may be taxed in the other state but *only so much of them as is attributable to that permanent establishment.* In other words, if an American company carries on business in South Africa, the portion of the profits of that American company that are attributable to the business carried on in South Africa will be taxed in South Africa. The remainder of the business profits of the American company will be taxed elsewhere.

Article 7.1 of the double tax agreement concluded between South Africa and the United Kingdom provides for a similar apportionment.[206]

3.5. CONCLUSION

The South African model of taxation is primarily residence based in that persons and companies who are resident in South Africa are taxed in the Republic on their worldwide income. There is, however, an element of the source principle retained in respect of non-residents who are taxed on income generated within or deemed to be generated within the country. Notably, the application of the source principle is contained in double tax agreements concluded between South Africa and other

[205] Double taxation treaty between South Africa and the United States of America *GG 18553* of 1997-12-15.
[206] Double taxation treaty between South Africa and the United Kingdom *GG 24335* of 2003-01-31.

jurisdictions as a means to allocate a portion of business profits to each jurisdiction that generates that portion of the income. Accordingly, whilst the tax authorities have not wholly accepted the concept of apportionment of income, certain provision has been made for the apportionment of income in instances where part of such income is earned by a non-resident from a source within the Republic. Having separately considered the emergence of e-commerce as well as the general legal framework in which e-commerce exists, it is necessary to consider these two concepts together in order to ascertain the effects of e-commerce on the South African taxation legislation.

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CHAPTER FOUR

THE EFFECTS OF E-COMMERCE ON THE SOUTH AFRICAN TAXATION LEGISLATION

4.1. INTRODUCTORY REMARKS

As with all advances in technology, the development of e-commerce as a means to do business has resulted in an abundance of both opportunities and challenges. The opportunities pivot around the ability of enterprises to conduct their businesses with a higher degree of efficiency and thereby expand the potential target market of the business to the world at large. On the other hand, the expansion of the commercial market presents enormous challenges to the international taxation rules which are reliant upon territorial and personal bases of tax jurisdiction.[207]

In the circumstances, the challenges posed to the international tax regime include certain feasibility questions as to whether the current international tax laws can be developed and applied to e-commerce, normative challenges as to whether the current regime *should* be applied to e-commerce and lastly, the conundrum regarding whether the global economy will accept the application of the developed regime to e-commerce.[208]

As previously discussed, if a business entity is not considered to be a resident of South Africa, i.e. if it is not incorporated, established or formed in South Africa, and has no place of effective management in the Republic[209], the South African Revenue Service may not levy tax on that entity's income unless the profits of the business can be attributed to a source located in South Africa.[210] With regard to the source of the income, the concept of a permanent establishment is

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[207] Azam 2007 *Virginia Journal of Law & Technology* 3.
[208] *Ibid*.
[209] Definition of "resident" in section 1 of the Income Tax Act 58 of 1962 ("the Act").
[210] Oliver and Honiball *International Tax: A South African Perspective* 420. See further Article 7(1) of the Organisation for Economic Co-operation and Development: *Model Tax Convention on Income and on Capital* (2008).

incorporated into many double tax agreements as a means of assigning the business profits of a foreign entity to a source in South Africa.

This permanent establishment concept is thus significant in that its existence allows the country in which the permanent establishment is situated, i.e. the source country, to tax its income as the permanent establishment is considered the "source" of the income, thereby connecting the business profits of a foreign entity to the source country, even if the permanent establishment does not have a separate legal existence as a resident in the Republic.[211]

This chapter will consider the definition of a "permanent establishment" and the evolution and development of the concept from its initial construction to what the concept signifies today and, in particular, its meaning, impact and utility in the South African context. Furthermore, in light of the burgeoning popularity of e-commerce, the effect of e-commerce on the permanent establishment concept will be discussed, as well as the specific challenges that e-commerce poses to the continued applicability of the permanent establishment concept in the global community.

4.2. EVOLUTION OF THE "PERMANENT ESTABLISHMENT" CONCEPT

The modern permanent establishment concept has its roots in German domestic law as a means to prevent double taxation by Prussian municipalities.[212] The concept was then developed by the Prussian courts to connote a physical structure as a geographic marker and the state within which such a structure was situated was afforded the right to levy tax on the profits of the structure.[213] The concept entailed both a *physical* and a *mental* element, in other words, the business entity was firstly required to have a fixed location (i.e. the physical requirement), and secondly the entity had to have the intention to perform its business activity at that

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[211] Oliver and Honiball *International Tax: A South African Perspective* 95. See further B Hoffart "Permanent Establishment in the Digital Age improving and stimulating Debate through an Access to Markets Proxy Approach" (2007) 6 *Nw J of Tech & Intell Prop* 106.

[212] AA Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle (Series of International Taxation)* (1995) 72-75. See further Hoffart 2007 *Nw J of Tech & Intell Prop* 109.

[213] Oguttu and Tladi 2009 *Stell LR* 75.

fixed location (i.e. the mental requirement).[214] This requirement for a "fixed place of business" was thereafter heavily relied upon in 1899 when the first international tax treaty was entered into between Austria-Hungary and Prussia,[215] and later when the German Double Taxation Act of 1909 was promulgated.[216]

Following World War I, there was a significant increase in international commerce in foreign markets and for feasibility and practicality reasons, business entities were required to create branches of the main entity in the other countries in which it did business.[217] In reaction to this expansion of international commerce, in 1927, the League of Nations developed the first draft convention on double taxation, which paid homage to the concept of a permanent establishment, and outlined various examples of permanent establishments such as branches, factories, agencies and offices.[218] The first understanding of the concept thus represented a compromise between an allocation of business profits to each of the entities that would be economically viable, and the feasibility of the increased administrative burden associated with the diversified allocation.[219] Furthermore, the draft convention distinguished between dependant agents and independent agents in relation to their respective autonomy from the main business. It was opined that deals made through a *bona fide* independent agent by an entity were not taxable upon the entity in the country in which the independent agent was located, as this did not constitute a permanent establishment of the former entity due to the relative disconnection from the business of the main entity.[220]

Over a decade later, the League of Nations published the first Model Tax Treaty for developing countries, a model which favoured a source-state based taxation system of business activities, without the requirement of a permanent establishment.[221] Three years later, however, the Model Tax Treaty was revised to

[214] Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* 72.
[215] Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* 75-77.
[216] Oguttu and Tladi 2009 *Stell LR* 75.
[217] *Ibid*.
[218] *Ibid*.
[219] Oguttu and van der Merwe 2005 *SA Merc LJ* 316.
[220] Oguttu and Tladi 2009 *Stell LR* 76; Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* 82-86.
[221] Oguttu and Tladi 2009 *Stell LR* 76.

include the existence of a permanent establishment as a condition for the source taxation of business profits.[222]

The rules relating to permanent establishments, as promulgated by the League of Nations, were thereafter embodied in the first report of the Organisation for Economic Co-operation and Development ("OECD"). This report further contained a definition of the permanent establishment concept, which definition was subsequently utilised in the formation of the OECD's Draft Taxation Convention on Income and Capital Tax in 1963. This early definition and the rules relating to the identification of a permanent establishment have thereafter been maintained in all successive OECD Model Tax Conventions and are therefore entrenched in the modern concept of what falls within the ambit of a permanent establishment.[223]

It is therefore noted that there are two main motivations behind the creation of the concept of a permanent establishment. Firstly, the mere existence of a permanent establishment of a foreign business entity is indicative of the fact that the entity conducts significant business in the source state, hence the need for such an establishment to exist at all.[224] The second reason underpinning the acceptance of the permanent establishment principle is that a foreign entity that makes a profit in the source state, through a permanent establishment, does so as a result of the commercial opportunities present in the source state's market, and those profits that are produced as a result of the opportunities of a particular state should be taxed *by* that state.[225] This concept thus represents a compromise between the interests of exporting nations, which derive revenue from taxing value added at the production stage, and importing nations, which derive revenue from taxing the income generated by the sale of such goods. This international equity in turn promotes international trade.[226]

The existence of a permanent establishment thus presupposes that the entity has a taxable presence in the country as the concept is based on the general premise

[222] Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* 98.
[223] Oguttu and Tladi 2009 *Stell LR* 76.
[224] *Ibid*.
[225] *Ibid*.
[226] *Ibid*.

that there ought to be a physical presence of the business before the source country can levy tax on its profits.[227]

4.3. THE PERMANENT ESTABLISHMENT CONCEPT IN SOUTH AFRICAN LAW

As previously discussed, section 1 of the Act defines a juristic person to be a resident of South Africa if it is incorporated, established or formed in the Republic, or if it has its place of effective management in the country. To avoid double taxation, this definition specifically excludes a juristic person that is deemed to be exclusively resident in another country for the purposes of any agreement entered into between the governments of the South Africa and that other country.[228]

It therefore follows that a non-resident entity is one which is not incorporated, established or formed in South Africa and does not have its place of effective management within the borders of the Republic. Therefore, a foreign entity could conceivably conduct considerable business in South Africa without being considered a resident, purely because its place of effective management is not in the country.

Notwithstanding the above, section 108(1) of the Act read with section 231(2) of the Constitution of the Republic of South Africa[229] ("the Constitution"), provides that the provisions of a double tax treaty are effective as if they had been incorporated into the Act, provided the treaty has been approved by parliament and published in the *Government Gazette*. Therefore when determining the tax liability of a foreign entity, one must keep in mind the effect of any double tax agreement that may exist between South Africa and the relevant foreign country. These agreements may determine that tax can only be levied in a particular country or, where the amounts are taxable in both countries, the double tax agreement may provide for a credit against the tax charged in one of the countries for the tax paid in another.[230]

[227] Oguttu and Tladi 2009 *Stell LR* 74-75.
[228] De Koker *Silke* para 5.2E. This part of the definition is effective as of 26 February 2003.
[229] Act 108 of 1996.
[230] Mosupa 2001 *Juta's Business Law* 161.

Most South African treaties are based on the Organisation for Economic Co-operation and Development Model Tax Convention ("OECD Model Convention") which utilises the concept of a “permanent establishment”,[231] however, it must be noted that South Africa is not a member of the OECD and is therefore not bound by its rules and recommendations.[232] Notwithstanding the aforegoing, section 1 of the Act has defined the permanent establishment concept with reference to the definition thereof in Article 5 of the OECD Model Convention and, as a treaty term, it was opined in *SIR v Downing* that South Africa ought to take the guidelines for interpretation issued by the OECD in its commentaries on the concepts used in the OECD Model Convention into account.[233] Therefore, these guidelines, as well as certain customary international law principles,[234] are of highly persuasive value and must be taken into account when interpreting the definition of the term “permanent establishment” in a South African context.

For the sake of completeness it is noted that Article 4 of the majority of double tax agreements entered into between South Africa and other jurisdictions regulate what constitutes "residence" for the purpose of the double tax agreement in question. For example, Article 4.1 of the double tax agreement concluded between South Africa and Mauritius specifically states that the term ‘resident of Mauritius’ includes a juristic person that, under the laws of Mauritius, is liable to tax therein by virtue of its residence or having its place of management in that country.[235]

Furthermore, Article 7 of the majority of double tax agreements entered into between South Africa and other jurisdictions regulates the attribution of business profits. For example, Article 7.1 of the double tax agreement entered into between South Africa and the United States of America states that the business profits of an

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[231] For example, see the Double taxation treaty between South Africa and Spain *GG 30837* of 2008-03-12.
[232] Oguttu and Tladi 2009 *Stell LR* 76.
[233] *SIR v Downing* 524.
[234] In terms of section 232 of the Constitution, South African courts are bound to apply customary international law, and example of which is the Vienna Convention on the Law of Tax Treaties (1969) which provides, in Article 32, that supplementary means of interpretation can be taken into account in order to interpret terms used in a treaty.
[235] Double taxation treaty between South Africa and Mauritius *GG 18111* of 1997-07-02.

American enterprise shall be taxable in America *unless* the enterprise carries on business in South Africa through a permanent establishment in the Republic.[236]

Of particular importance for the purposes of this thesis, Article 5(1) of the OECD Model Convention defines a permanent establishment as “a fixed place of business through which the business of an enterprise is wholly or partly carried on”.[237] From this, one can extract three core elements which underpin the permanent establishment concept: (1) there must be a place of business; (2) the place of business must be fixed; and (3) the business of the enterprise must, to some extent, be carried on through this fixed place of business.

With regard to the first element, that there must be a *place of business*, it is noted that a permanent establishment will only exist if the foreign business entity has a physical presence in the source state.[238] For the sake of determining what is indicative of a "place of business", whether the premises upon which the business is situated is rented or owned, the size of the premises, or the equipment required is irrelevant as these factors are variable and depend upon the nature of the business itself. For ease of reference, examples of such a physical presence are provided by Article 5(2) of the OECD Model Convention which states that a “place of business” could be a place of management, a branch, an office, a workshop, a factory, a mine, an oil or gas well, a quarry, or any other place for the extraction of natural resources, but excludes the use of facilities for activities of a preparatory or auxiliary nature, such as storage, display or delivery.[239] The existence of one of these examples is, however, not in itself conclusive, as these *prima facie* permanent establishments must still satisfy the additional requirements set out in Article 5(1) of the OECD Model Convention.

Once it has been established that there is a place of business, in order to constitute a permanent establishment as defined, the place of business must be *fixed*, i.e. there must be a specific geographical location in which the business is

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236 Double taxation treaty between South Africa and the United States of America *18553* of 1997-12-15.

237 Organisation for Economic Co-operation and Development Model Tax Convention Commentary on Article 5: Permanent Establishment (2003) para 2.

238 Olivier 2002 *SALJ* 871.

239 Article 5(2) and 5(4) of the OECD Model Convention.

situated, and there must be a degree of permanence at this geographical location.[240] Accordingly, it could be said that a fixed place of business will exist where any premises, installation, facility or space is regularly and periodically used by an enterprise for the purposes of generating the business profits.[241] Due to the varying contexts in which a business can operate, it is not entirely necessary for the business to be physically connected to the ground, but the commercial and geographical aspects of the business ought to exist as a coherent whole.[242] This coherent whole should not be temporary in nature,[243] and the business operations must be carried out with a certain degree of regularity, even if there are intermittent interruptions of the operations.[244]

The last element, namely that the *business of the enterprise must be carried on either wholly or partly through the fixed place of business*,[245] implies that the business activities in question must be performed at a particular location that is at the disposal of the enterprise.[246] This does not necessarily suggest that individuals must be present to run the enterprise, and accordingly it is submitted that the presence of fully automated equipment that is operated and maintained by an enterprise may constitute a permanent establishment in the source country, if it satisfies the preceding criteria.[247]

In addition to Article 5(1) of the OECD Model Convention which sets out what constitutes a permanent establishment, Article 5(4)(a)-(f) of the OECD Model Convention outlines certain activities which are explicitly excluded from the ambit

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[240] Oguttu and Tladi 2009 *Stell LR* 77.
[241] Organisation for Economic Co-operation and Development Model Tax Convention Commentary on Article 5: Permanent Establishment (2003) para 4.
[242] Oguttu and Tladi 2009 *Stell LR* 78. See further H Pijl "The Concept of Permanent Establishment and the Proposed Changes to the OECD Commentary with special reference to Dutch Case Law" (2002) *Bull Int Fiscal Doc* 554 at 555.
[243] Oliver and Honiball *International Tax: A South African Perspective* 99.
[244] Organisation for Economic Co-operation and Development Model Tax Convention Commentary on Article 5: Permanent Establishment (2003) paras 6.1 and 11.
[245] Organisation for Economic Co-operation and Development Model Tax Convention Commentary on Article 5: Permanent Establishment (2003) para 7.
[246] Oguttu and Tladi 2009 *Stell LR* 78. See further KJ Levouchkina "Relevance of Permanent Establishment for Taxation of Business Profits and Business Property" in Hans-Jorgen & Zuger (eds) *Permanent Establishments in International Tax Law* (2003) 20-21.
[247] Organisation for Economic Co-operation and Development "OECD Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention Article 5" (2000) http://www.oecd.org/dataoecd/46/32/1923380.pdf (accessed on 5 July 2012) 36.

of the definition. The commonality between these exclusions is that they are generally preparatory or auxiliary in nature.[248] In practice, it is often difficult to ascertain what it is that constitutes "preparatory or auxiliary" activities and how these differ from other activities, however, the OECD is of the opinion that the decisive criterion in this determination is whether or not the activity itself forms an *essential* and *significant* part of the activities of the enterprise as a whole.[249]

In addition to the exclusions to the concept, Article 5(5) of the OECD Model Convention sets out certain instances in which an enterprise is *deemed* to be a permanent establishment, even if it does not have a fixed place of business.[250] To this end, Article 5(5) provides that where a dependant agent has *authority to conclude contracts on behalf of a foreign enterprise* and *repeatedly* exercises this authority in a state, the dependant agent is deemed a permanent establishment in that state.[251] In other words, where a non-resident habitually transacts business in a country through an entity and that entity operates under the control of and pursuant to detailed instructions from the non-resident, and the risk is born by the non-resident instead of the entity, this is indicative of a dependant status.[252]

The rise of electronic commerce has, however, made it difficult to identify a taxable presence in a particular country due to the fact that a business entity may not have a physical presence in the source country or require the assistance of a dependant agent.[253] Accordingly, a business entity could potentially conduct extensive and repeated commercial activities in a source country via the Internet without ever establishing a “permanent establishment” in the traditional sense of the word.

[248] Oguttu and Tladi 2009 *Stell LR* 78.
[249] Organisation for Economic Co-operation and Development Model Tax Convention Commentary on Article 5: Permanent Establishment (2003) para 24.
[250] Oguttu and Tladi 2009 *Stell LR* 79.
[251] *Ibid;* Oliver and Honiball *International Tax: A South African Perspective* 105.
[252] Organisation for Economic Co-operation and Development Model Tax Convention Commentary on Article 5: Permanent Establishment (2003) para 37-38.
[253] Oguttu and Tladi 2009 *Stell LR* 75.

4.4. EFFECT OF AND CHALLENGES POSED BY E-COMMERCE TO THE PERMANENT ESTABLISHMENT CONCEPT

As previously elucidated, the rise of popularity of e-commerce and the acceptance of the Internet as a trading platform has had profound and far-reaching effects on the taxation of both individuals and companies as the propensity for businesses to move some or all of their business activities to the Internet rises. Fast-growth emerging economies such as South Africa have displayed significant proclivity towards online trading. Coupled with the higher incidences of cross-border transactions and the inherently transient nature of e-commence, this poses significant challenges to the traditional concept of a "permanent establishment" as constituting the connective fibre between a country and certain profits.

Traditionally, international companies required a degree of physical presence within a foreign market in order to engage in business enterprises in that country, for example a sales office to facilitate advertising and sales promotions.[254] In terms of the double tax agreements permitting source countries to tax the business profits attributable to these intermediaries, the intermediary in question had to be considered to constitute a "permanent establishment" in terms of the definition provided in the tax treaty itself.

In the past, international companies employed dependent agents in foreign countries to perform various functions as an intermediary, such as finalising complex contracts or exploring new business opportunities, however, the advent of the Internet has eliminated this strict reliance on human intermediaries, due to the fact that modern technology allows for fully automated order filing, contract negotiating and payment processing.[255]

The development of the Internet has therefore allowed online retailers to accomplish much of their sales and advertising strategies via a website that allows direct interaction with and transfers such transaction costs to the customers, thus

[254] AA Skaar "Erosion of the Concept of Permanent Establishment: Electronic Commerce" in Lindencroma, Lodin & Wiman (eds) *International Studies in Taxation: Law and Economics (Series on International Taxation No. 21)* (1999) 307 and 309-310.
[255] Oguttu and Tladi 2009 *Stell LR* 82.

eliminating the need for a physical intermediary in the source state.[256] Furthermore, customers may purchase commodities or gain access to services without ever having to leave the comfort of their own homes. This has enabled international corporations to centralise many of their operations in one jurisdiction, usually the country in which they are registered, despite conducting significant business in a multiplicity of foreign countries.[257] As a result of the international company's ability to shift part of its operations from permanent establishments, as defined, to the Internet and thus facilitate significant business transactions electronically, there is great potential for the reduction of the amount of income that may be attributable to an international company in a foreign country.

As previously discussed, the permanent establishment principle is used in double tax agreements to establish a jurisdictional nexus between a particular country and a non-resident taxpayer.[258] In this regard, the permanent establishment principle qualifies the source rule in that it enables the government in the source country to levy tax on the business profits of a non-resident entity, provided those business profits are attributable to a permanent establishment in the source country.[259]

As e-commerce limits the need for a physical presence and makes it difficult to trace transactions, the traditional concepts contained in the extant definition are inadequate to deal with the ever-increasing growth of e-commerce in the digital era. Accordingly, a business may conduct substantial business activities in a particular country whilst never attaining the required level of physical presence necessary to establish a tax nexus in terms of a double tax agreement.

It has been argued that while e-commerce may have changed the *nature* and *location* of certain business activities and may have created new products and services, some physical activity is still required to actually create and sustain any business enterprise. This is due to the fact that e-commerce has not completely eliminated the need for capital, labour and other property to ensure development,

[256] Oguttu and Tladi 2009 *Stell LR* 81; Shapiro 1998 *Ohio North University Law Review* 795; Oguttu and van der Merwe 2005 *SA Merc LJ* 305.
[257] Oguttu and Tladi 2009 *Stell LR* 81.
[258] Oguttu and van der Merwe 2005 *SA Merc LJ* 316.
[259] Organisation for Economic Co-operation and Development Discussion Document: *Are the Current Treaty Rules for Taxing Business Profits Appropriate for e-Commerce?* (2007) 7.

marketing and delivery of an entity's products and services.[260] The argument follows that, due to economic considerations, an enterprise would thus have to invest directly in local resources to ensure market growth at some point.[261] For example, although an American company may sell its products via a website to South African consumers, at some stage in the business operations, it would be prudent for the American company to open a branch in South Africa to centralise the distribution of its products, lower the shipping costs by importing the products in bulk and enhance the development of the business as a whole.

Should the above be accepted, the period between the initiation of the business enterprise and the point at which a physical presence is a necessary extension of the enterprise's business is still a concern, as well as businesses which do not by their very nature require any physical presence and whose operations are conducted wholly over the Internet. In these instances, it is proposed by Buys and Cronje[262] that the business presence of an e-commerce enterprise will exist as either a website or a server, however, the question remains whether a website or server as purported above may be treated as a "permanent establishment" in a source country.[263]

4.5. CONCLUSION

The concept of a "permanent establishment", for the purposes of attributing business profits to a source country, is defined in Article 5(1) of the OECD Model Convention as "a fixed place of business through which the business of an enterprise is wholly or partly carried on". Although South Africa is not a member of the OECD, for all intents and purposes, this definition is applicable in South African law. The definition, however, is heavily reliant on a physical presence of the entity existing within the Republic. The rise of popularity of e-commerce and the acceptance of the Internet as a trading platform has had profound and far-reaching

[260] Organisation for Economic Co-operation and Development Discussion Document: *Are the Current Treaty Rules for Taxing Business Profits Appropriate for e-Commerce?* (2007) 15.
[261] Organisation for Economic Co-operation and Development Discussion Document: *Are the Current Treaty Rules for Taxing Business Profits Appropriate for e-Commerce?* (2007) 19-20.
[262] Buys and Cronje *Cyberlaw @ SA II: The Law of the Internet in South Africa* 303; Oguttu and van der Merwe 2005 *SA Merc LJ* 317.
[263] Oguttu and van der Merwe 2005 *SA Merc LJ* 317.

effects on the taxation of both individuals and companies as the propensity for businesses to move some or all of their business activities to the Internet rises, especially in fast-growth economies such as South Africa. With e-commerce businesses able to accomplish much of their sales and advertising strategies through a website, directly interact with customers and thereby centralise their operations in one jurisdiction despite conducting significant business operations in many jurisdictions, this method of doing business radically limits the need for a physical presence. Accordingly, the traditional concepts contained in the present definition of a permanent establishment are wholly inadequate to deal with the ever-increasing growth of e-commerce in the digital era. In this context, it is therefore of utmost importance that a solution is developed to address the limitations of the present construction of the permanent establishment principle.

CHAPTER FIVE

POSSIBLE SOLUTIONS TO THE CHALLENGES POSED BY E-COMMERCE

5.1. INTRODUCTORY REMARKS

This thesis has already discussed the growth of e-commerce in the modern world and the difficulties faced in applying the traditional source based rules, in particular the permanent establishment concept, in this context due to the former's inherent nature being mobile and intangible, whilst the latter relies heavily on a degree of permanency and a fixed geographical presence.

In light of the above, the tax writers have suggested several policy proposals in an effort to address these challenges. The most notable of these solutions is the one proposed by the Organisation for Economic Co-operation and Development ("OECD") due to the sheer magnitude of countries that subscribe to the solution either in whole or in part.

In order to ascertain the best path for a development of this area of law in the South African context, it is thus necessary to consider the various other proposals that have preceded this thesis. Accordingly, this chapter seeks to explore the various solutions, and criticisms of these solutions, that have been propagated to address the concerns posed by the rising popularity of e-commerce. In considering these proposals, the OECD solution will be considered in depth, as well as the virtual permanent establishment, consumption based taxation, markets proxy approach, self-regulation, formula taxation, personal jurisdiction and withholding tax theories.

5.2. HOW THE OECD ADDRESSES THE CHALLENGES

In an effort to address the challenges posed to the traditional permanent establishment principle by the advent of e-commerce, the OECD has developed certain guidelines which have sought to adapt the traditional principles to deal with the current technological climate.[264] In particular, the OECD has considered whether a website or a server qualifies as a permanent establishment which has enough permanence to be considered a deemed dependant agent or a fixed place of business through which the business of the enterprise is carried on.

5.2.1. WEBSITES

An Internet website is essentially a location on the World Wide Web and is what appears on the computer screen when a web address is accessed.[265] A website consists of the electronic data and software stored on a server and allows a business to directly interact with users generally and in particular, its customers.[266] Due to the fact that a website only exists in the intangible realm of the Internet, it has been described as a "virtual office",[267] however, its intangibility means that it does not provide a regular link between the place of business of an enterprise and a specific, physical and geographical point.[268]

It is because of this intangible nature that a website cannot meaningfully be construed to contain any facility that is tantamount to a fixed place of business equal to a permanent establishment. A website does not have specific premises, machinery, equipment or the like and the software and data constituting the website does not have the degree of permanency required to be considered to constitute a premises. It is accordingly, albeit summarily, submitted that a website therefore cannot qualify as a permanent establishment.[269]

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[264] Oguttu and Tladi 2009 *Stell LR* 82.
[265] *Ibid*.
[266] Oguttu and Tladi 2009 *Stell LR* 83.
[267] BJ Arnold and MJ McIntyre *International Tax Primer* 2 ed (2002)153-154.
[268] Oguttu and Tladi 2009 *Stell LR* 83.
[269]Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) para 42.2; Organisation for Economic Co-operation and Development: *Clarification on Permanent Establishment* (2000) 5.

5.2.2. SERVERS

If a website is considered to be too intangible a construct, the natural question thus arises as to whether the server upon which the electronic data is stored could constitute a permanent establishment for the purposes of assigning a tax burden.

A server is essentially an automated piece of equipment through which the website itself is accessible.[270] Due to the fact that a server has an actual presence, the OECD Commentary provides that the location of the server may constitute a fixed place of business for the enterprise that operates that server.[271] It follows then that a server used with enough regularity could therefore be considered a permanent establishment if it is at the disposal of the enterprise (i.e. *controlled* by the entity), and used for the advancement of the enterprise's interests.[272] Accordingly, if the enterprise controls and operates the server on which the website is stored and used, then the place where that server is located could constitute a permanent establishment as the server and its location are at the disposal of the enterprise, much like the assets at a fixed place of business.

Notwithstanding the above, to be considered a "fixed place of business" within the meaning of Article 5(1) of the Organisation for Economic Co-operation and Development Model Tax Convention ("OECD Model Convention"), even if the enterprise has a server at its disposal, the server must also *remain at a certain place* for a sufficient period of time so as to depict a degree of permanence and connection to the geographical location.[273]

Furthermore, even if the enterprise has a server at its disposal and the server constitutes a fixed place of business, in order to constitute a permanent establishment, it is necessary for the business of the enterprise to be *wholly or*

[270] Organisation for Economic Co-operation and Development: *Clarification on Permanent Establishment* (2000) 5; Buys and Cronje *Cyberlaw @ SA II: The Law of the Internet in South Africa* 303.
[271] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) 42.2.
[272] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) para 42.3; Oguttu and Tladi 2009 *Stell LR* 83.
[273] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) para 42.4.

partly carried on through the place where the server is located.[274] Whether the business of the entity is wholly or partly carried on through the place where the server is located is a factual question to be determined on a case-by-case basis taking into account the business of the enterprise and whether or not personnel are required to carry on business activities at that location.[275] If personnel are required, it is submitted that this will lend further credence to the conclusion that the business of the enterprise is, to some degree, carried on through this location.

The OECD Commentary further provides that a server will only be considered a permanent establishment of the particular enterprise if it *does not fall within the ambit of the specific exclusions* provided for in Article 5(4) of the OECD Model Convention.[276] In terms of Article 5(4) of the OECD Model Convention, where the activities carried on through a server are restricted to auxiliary or preparatory activities, the server will not constitute a permanent establishment.[277] Examples of such activities include the provision of a communication link between customers and suppliers, advertising of goods or services (such as through the display of a catalogue) relaying information through a mirror server for the purposes of security and efficiency, gathering market data for the enterprise and supplying such information to the public at large, customers and/or for research purposes.[278] The reason for this, it is submitted, is that such activities do not provide the necessary nexus to give rise to a taxation burden in the country in terms of the traditional rules, and this distinction between preparatory and auxiliary activities on the one hand, and significant business activities on the other, ought to be maintained. If, however, the activities go further than this in that they form the main or core function of the enterprise and are an important and significant part of the business

[274] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) 84.
[275] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) para 42.5-42.6.
[276] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) para 42.7.
[277] Oguttu and Tladi 2009 *Stell LR* 84.
[278] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) para 42.7.

activities of the enterprise, the server shall, in terms of the OECD Model Convention, be deemed to be a permanent establishment.[279]

In summation, a server will only be deemed to be a permanent establishment based on the concept of a "fixed place of business" when an enterprise (1) carries on business through a website that (2) has a server (3) at its own disposal, (4) at a fixed location, and (5) the business of the enterprise is not of a preparatory or auxiliary nature.[280] This, however, rarely happens in practice as very few enterprises carry on business through their *own* servers and consequently would not be taxable in terms of the current guidelines provided by the OECD.[281]

Accordingly, it is submitted that the solution provided by the OECD Model Convention merely represents a theoretical answer without due regard to the practicalities concerned. Whilst *prima facie* useful, this proposal does not take the argument any further and the remote possibility of the OECD solution being capable of successful implementation renders the proposal nugatory.

5.2.3. INTERNET SERVICE PROVIDERS ("ISPs")

For the sake of completeness, it is noted that when an enterprise conducts its business through a website that is hosted on the server of an ISP, this kind of hosting arrangement does not result in the server and its location being controlled by and at the disposal of the enterprise, despite the fact that the website may be hosted on a specific server at a specific location.[282] In the circumstances, such a server cannot be considered to be a permanent establishment as it falls foul of the requirements contained in the OECD Commentary, namely the requirement of control.[283]

[279] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) para 42.8.
[280] Oguttu and Tladi 2009 *Stell LR* 84.
[281] *Ibid*.
[282] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) para 42.3.
[283] *Ibid*.

Accordingly, the question arises as to whether an ISP company that supplies an enterprise with connections to the Internet and hosts the websites of several enterprises on its own servers could constitute a dependent agent permanent establishment of the enterprises that carry on e-commerce through the websites hosted on servers owned and operated by these ISPs.[284]

The OECD Commentary explicitly provides that an ISP does not constitute a dependant agent of the enterprise to which the website belongs as it does not ordinarily have the authority to conclude contracts in the names of these enterprises.[285] Furthermore, ISPs customarily act independently and the ordinary course of their own business entails hosting websites or other applications of *many* different enterprises, therefore it could not be imputed to constitute a dependant agent of each of these foreign enterprises.[286] To contend that the ISP, merely by virtue of conducting its own business, could constitute a permanent establishment of a foreign entity would thus, it is submitted, be absurd.

5.3. DISSENTIONS FROM THE OECD'S GUIDELINES ON THE TAXING OF SERVERS AS PERMANENT ESTABLISHMENTS

It is submitted that the current OECD guidelines utilise the traditional concepts applicable to long distance selling and apply these concepts to the prevailing technological climate without sufficient adaptation. In the circumstances, it appears that the OECD is of the view that the existing international tax rules and principles are capable of handling the emerging issues relating to the taxation of e-commerce business profits.

It is respectfully submitted, however, that the preservation of traditional international tax principles may become increasingly obsolete in the world of e-commerce.[287] The reason for this is that the challenges posed by e-commerce originate from the basic character of the Internet as a global, borderless, intangible

[284] Oguttu and Tladi 2009 *Stell LR* 84-85.
[285] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2003) para 42.10.
[286] Organisation for Economic Co-operation and Development: *Clarification on Permanent Establishment* (2000) 7.
[287] Oguttu and Tladi 2009 *Stell LR* 87.

and anonymous platform, whilst the extant international taxation regime is state-based and focussed on territorial borders and physical presence.[288] These two ideologies are therefore inherently and fundamentally opposed.

In the circumstances, a number of countries disagree with the OECD guidelines regarding the taxation of permanent establishments. For example, Canada's Tax Administration does not apply a blanket approach to the issue and whether or not a server falls within the ambit of the definition of a permanent establishment will depend on the facts and circumstances of each particular case in a manner consistent with the Department's published interpretations and rulings.[289]

On the other hand, the German tax authorities issued a pronouncement in 1999 that a server would not be considered a permanent establishment under the OECD Model Convention because the activities associated therewith were considered to be preparatory in nature.[290]

Furthermore, the United Kingdom maintains that a server used for the purposes of e-commerce, either alone or together with websites, will not constitute a permanent establishment for tax purposes.[291]

Not all OECD countries have expressed a firm opinion in this regard. For example, Spain and Portugal have articulated general reservations about the OECD Commentary and have announced that as the study of e-commerce taxation is in progress, they will not take a firm stance on the guidelines until the OECD has come to a final conclusion on the matter.[292] Similarly, Chile and Greece have stated that they do not adhere to all the interpretations in the guidelines in this

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[288] Azam 2007 *Virginia Journal of Law & Technology* 3.
[289] H Dhaliwal "Electronic Commerce and Canada's Tax Administration: a Response by the Minister of National Revenue to his Advisory Committee's Report on Electronic Commerce" (1998) *Tax Executive* http://www.thefreelibrary.com/Electronic+commerce+and+Canada's+tax+administration.-a021250209 (accessed on 26 June 2012) 6.3.2.4.
[290] Oguttu and Tladi 2009 *Stell LR* 86.
[291] *Ibid*.
[292] *Ibid*. Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2008) para 45.11.

regard,[293] and Italy has clarified that, although generally in agreement with the OECD guidelines, its own jurisprudence is not to be ignored in the interpretation of cases falling within the ambit of this discussion.[294]

The United States Treasury Department has also rejected the OECD's view that a server may constitute a permanent establishment,[295] and the Dutch Advisory Group on electronic commerce has recommended to the Dutch tax authorities not to regard the mere electronic presence of an entity through a server as constituting a permanent establishment situated in the Netherlands.[296]

As previously stated, South Africa is not a member of the OECD and accordingly is not bound to tax servers as permanent establishments, however, as South Africa has not indicated a reservation regarding the guidelines, as it is entitled to do notwithstanding its non-member status, it may be inferred that it has accepted the OECD's interpretation.[297]

5.4. CRITICISMS AGAINST THE OECD'S GUIDELINES ON THE TAXING OF SERVERS AS PERMANENT ESTABLISHMENTS

Although a server may *prima facie* appear to fall within the traditional definition of a permanent establishment as contained in international tax treaties, the rapid developments in e-commerce contrasted with the relatively slow development of the traditional permanent establishment principle that emphasises the need for a physical presence within the source country, have effectively hamstrung the ability of many jurisdictions from taxing the profits arising from online businesses.[298]

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[293] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2008) para 45.6.
[294] Organisation for Economic Co-operation and Development: *Model Tax Convention Commentary on Article 5: Permanent Establishment* (2008) para 45.10.
[295] US Department of Treasure, Office of Tax Policy "Selected Tax Policy Implications of Global Electronic Commerce" (1996) http://www.treasury.gov/resource-center/tax-policy/Documents/internet.pdf (accessed on 26 June 2012).
[296] Oguttu and Tladi 2009 *Stell LR* 86.
[297] *Ibid*.
[298] Oguttu and Tladi 2009 *Stell LR* 87.

There are three main criticisms often raised against the OECD's guidelines in respect of the taxation of servers as permanent establishments. These criticisms are that (1) there are inherent difficulties in determining the location of servers, (2) there is a possibility of increased tax avoidance schemes, and (3) there are administrative and enforcement challenges associated with taxing profits attributable to the software functions of servers.[299]

5.4.1. LOCATION OF THE SERVER

Firstly, it is submitted that, due to the highly mobile and flexible nature of servers and the malleability of the actual software code through which the functions of the server are performed, it will be exceedingly difficult to locate and tax the profits generated by servers.[300] Furthermore, as the United States Treasury Department submits, users of servers are wholly indifferent to the location thereof and thus a server or similar equipment is not a sufficiently significant element in the generation of business profits so as to be construed as a permanent establishment in the traditional sense.[301]

Furthermore, the location of a server is easily transportable which is highlighted by the practically instantaneous manner in which programs can be transferred from one server to another in a different jurisdiction.[302] In fact, the software functions within a server form part of the hardware and software infrastructure of the Internet as a whole and are thus easily shifted from one state to another without affecting the underlying transaction.[303]

For instance, it is common for businesses to establish mirror sites hosted on different servers and then redirect some customers to those mirror sites, thereby alleviating electronic traffic during high-traffic periods.[304]

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[299] *Ibid*.
[300] W Hellerstein "Transaction Taxes and Electronic Commerce: designing State Taxes that work in an Interstate Environment" (1997) 50 *Nat Tax J* 593; Oguttu and Tladi 2009 *Stell LR* 87.
[301] US Department of Treasure "Selected Tax Policy Implications of Global Electronic Commerce".
[302] A Cockfield "Transforming the Internet into a Taxable Forum: A Case Study in E-Commerce Taxation" (2001) 85 *Minn L Rev* 117 at 1259. Oguttu and Tladi 2009 *Stell LR* 87.
[303] *Ibid*.
[304] Oguttu and Tladi 2009 *Stell LR* 87.

A consequence of the mobility of servers also means that the location of a server often bears little to no relationship to the location of the business or indeed the essential economic activities of an enterprise, and need not have any geographical connection to the activities that actually do add value to the business activities and create income for the enterprise.[305]

Taken one step further, it is submitted that a server need not even exist! The technological advances in peer-to-peer networking have removed the strict necessity of a central server and users are increasingly able to share their own files and trade digital products without relying on a centralised server at all.[306] In circumstances where an enterprise utilises the other benefits of peer-to-peer networking, such as additional bandwidth and processing power with each additional user, so the difficulty of asserting that the business is being conducted through a server owned or leased in a country increases.[307]

5.4.2. TAX AVOIDANCE SCHEMES

Due to the ease of mobility of servers, the establishment of a permanent establishment in the traditional sense of the word may be avoided by an enterprise simply by moving the business operations to a server in another country before the conditions of being "fixed" at one location are satisfied. This will have the effect of frustrating any attempt to levy tax on the business profits of the enterprise situated in the source country.[308]

On the other hand, there are significant tax avoidance opportunities if servers are considered to constitute permanent establishments as a server could be purposefully located in a tax haven or low tax jurisdiction and merely uploaded, altered or repaired from a remote location.[309] Accordingly, an enterprise could

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[305] Oguttu and Tladi 2009 *Stell LR* 88.
[306] M Talber "Internet Telephony over Peer-to-Peer Networks" (2007) http://www.articles3k.com/article/301/165404/Internet_Telephony_over_Peer_to_Peer_Networks/ (accessed on 27 June 2012).
[307] Oguttu and Tladi 2009 *Stell LR* 88.
[308] *Ibid*.
[309] *Ibid*.

maintain its main server in a tax haven to perform the business activities as defined, and then merely host its website on a secondary server, not directly or indirectly controlled by the enterprise, in the target market – the enterprise in this instance will not attract income tax in the source country as merely hosting a website on a foreign-owned server does not in itself place the server at the disposal of the enterprise.[310]

In fact, due to the inherent interconnectedness of the Internet, it is relatively easy to disperse an enterprise's functions over many servers located in multiple jurisdictions.[311] For example, each of the elements of a transaction may be separated and disseminated so that each function on its own could only be considered auxiliary or preparatory in nature, but the cumulative effect of being linked via the Internet creates a "*viable business that is not subject to tax in any jurisdiction*".[312]

5.4.3. ADMINISTRATIVE AND ENFORCEMENT CHALLENGES

The ability of the authorities to collect taxes could be summarised as being wholly dependent upon the identification and location of the taxpayers, the identification and verification of taxable transactions, the ability to establish a link between taxpayers and their taxable transactions, and the ability to enforce payment of any taxes levied.[313]

As previously discussed, electronic transactions obscure the identity and location of both parties to the transaction as the identity of the individuals and/or the businesses transacting becomes rather irrelevant in the anonymous world of the Internet.[314] The use of electronic money further enhances the namelessness of e-commerce as no physical money has to change hands to effect a transaction and payments can be made merely by entering banking details online. This leads to

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[310] Oguttu and Tladi 2009 *Stell LR* 89.
[311] *Ibid*.
[312] *Ibid*.
[313] Arnold and McIntyre *International Tax Primer* 56.
[314] Oguttu and van der Merwe 2005 *SA Merc LJ* 320.

the easy concealment of transactions as the transactions are virtually undetectable in many instances.[315]

In a country like South Africa, this poses substantial risks as the identification of possible taxpayers is largely reliant upon the identification of taxable transactions.[316] In this context, e-commerce makes it exceedingly difficult to obtain reliable transaction information which is essential for the determination of the value of the taxable element of a transaction.[317] Furthermore, these issues compound the difficulties faced in linking any activities on the Internet to a specific party associated with the activities.[318]

Although the repeal of the Computer Evidence Act[319] by the promulgation of the Electronic Communication and Transaction Act[320] ("ECTA") and the subsequent amendment of ECTA in 2003[321] has expanded South Africa's traditional basis for tax and auditing to include both physical *and* electronic records, it is trite that electronic records may be easily altered without trace, or may be encrypted to conceal certain transaction information.[322]

Quite simply, it is not administratively or economically feasible for the tax authorities to go through hundreds of lines of computer code and the intangible and highly mobile nature of computer code would make the determination of the amount of added value provided through the specific server functions exceedingly challenging, time consuming, and inefficient.[323] Furthermore, a multitude of double tax agreements would also have to be entered into in order to cover every possible loophole and avoid double taxation.

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315 *Ibid*.
316 *Ibid.*
317 *Ibid*.
318 Oguttu and van der Merwe 2005 *SA Merc LJ* 321.
319 Act 57 of 1983.
320 Act 25 of 2002.
321 In terms of the Revenue Laws Amendment Act 45 of 2003.
322 Oguttu and van der Merwe 2005 *SA Merc LJ* 321. Doernberg *Electronic Commerce and Multijurisdictional Taxation* 390.
323 Oguttu and Tladi 2009 *Stell LR* 89.

In addition to the above, a taxation system as suggested in the OECD Guidelines would result in a tremendous tax compliance burden for taxpayers in countries that utilise a self-assessment system.[324] South Africa is one of those countries that imposes a duty upon its citizens to register for tax purposes upon pain of criminal sanction.[325] Multinational enterprises would thus be compelled to incur significant compliance costs in order to fulfil the reporting obligations of every jurisdiction where a server may be located. This would create an unfavourable climate for the further development of e-commerce, which would in turn hamper the growth and the many benefits to be gained by trading electronically in a global community.

Accordingly, it is submitted that for a server to be construed as a permanent establishment constitutes an artificial means of addressing the problems associated with the taxation of e-commerce, whilst ignoring the practical realities at play.

5.5. POSSIBLE SOLUTIONS POSTULATED FOR THE TAXATION OF E-COMMERCE

The concept of e-commerce is not new to taxation strategists and academics alike. In addition to the solution proposed by the OECD guidelines, a number of theories have been formulated in an effort to address the challenges posed by e-commerce.

It is submitted that each of these theories has merit and a certain degree of appeal in its own right, but none have obtained universal acceptance and application. In order to formulate a strategy that will suitably address the concerns outlined above within the South African context, it is therefore of assistance to draw on the previous theories postulated by other writers and in so doing undertake an assessment of the relative advantages and disadvantages of each.

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[324] *Ibid.*
[325] Section 75 of the Act.

5.5.1. VIRTUAL PERMANENT ESTABLISHMENT

One of the first theories hypothesised is that of the creation of a virtual permanent establishment. Hinnekins[326] suggests that the most effective way to deal with the challenges posed by e-commerce is to *create* a tax nexus in the source country even if there is no fixed place of business, i.e. the tax nexus operates as a fiction by enabling jurisdiction solely for the purpose of taxation, on the basis of a virtual permanent establishment in a source country.

The virtual permanent establishment principle has its basis in the removal of the requirement for there to be a physical, fixed place of business in the source country, thereby removing what is generally considered to be the largest hurdle in applying the traditional source principles in the context of electronic commerce.[327]

It is submitted that such a resolution is inherently superficial and therefore only *prima facie* effective as it creates difficulties in determining the method to be applied in attributing business profits to a simulated permanent establishment.[328] Furthermore, even if a mechanism could be developed whereby business profits could be attributed to a virtual permanent establishment, it would only be feasible where *active* business profits exist, as the difficulties in implementing such a system would prove to be practically insurmountable in the case of passive business profits.[329]

Accordingly, this theory does not sufficiently address the underlying concerns in considering the problems posed by e-commerce and comes with its own set of problems to be surmounted. It would therefore require rigorous legislative intervention to implement this theory, such intervention not necessarily bearing the requisite correlation to the practical realities and hurdles of implementation.

[326] L Hinnekins "Looking for an appropriate Jurisdictional Framework for Source State Taxation of International Electronic Commerce in the Twenty-First Century" (1998) 26 *Intertax* 192 at 199.
[327] Oguttu and Tladi 2009 *Stell LR* 92.
[328] *Ibid.*
[329] *Ibid*.

5.5.2 CONSUMPTION BASED TAXATION

Some commentators, of them perhaps the most vehement being Cockfield, have proposed that the entire concept of a permanent establishment as it traditionally exists, premised on the location where the value or profit is created, is entirely obsolete in the digital era, and thus the appropriate test ought not to focus only on the wealth-creating activities, but in certain circumstances, should also be mindful of the location of consumption.[330]

Cockfield[331] draws a distinction between e-commerce transactions that require significant human activity to be performed on the one hand (such as digital legal advice), and services that are largely performed by machines, including software programmes (such as the purchase of digitised products). The former, it is argued, would be taxable at the place where the service was performed, in terms of the activities test and the traditional source-based international taxation rules, whilst the latter would be treated as a transfer of tangible or intangible property and thus taxed in the country in which the service is used.[332]

This concept has its roots in the cost and benefit theories which hold that the taxpayer should pay taxes that are equivalent to the benefits received through its use of the infrastructure, public goods and natural resources of a country.[333] This "equivalence theory" is premised on the undeniable fact that a large part of the cost of running the government is spent on maintaining a suitable business environment, and therefore the theory holds that businesses that benefit from the market so created ought to contribute to the maintenance of such an environment through the payment of taxes.[334] In other words, in respect of mechanised service transactions, the source country would be permitted to levy tax on the business

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[330] *Ibid*.
[331] AJ Cockfield "Balancing National Interests in the Taxation of Electronic Commerce Business Profits" (1999) 74 *Tul L Rev* 133-217 at 152.
[332] *Ibid*.
[333] Hoffart 2007 *Nw J of Tech & Intell Prop* 117-118.
[334] TS Adams "The Taxation of Business" (1917) *National Tax Association* http://faculty.law.wayne.edu/tad/Documents/Research/adams-tax_business_NTA_Proceedings-mjm.pdf 186-187 (accessed on 12 August 2012).

profits earned from the e-commerce transaction, in its capacity as the country of consumption.[335]

Accordingly, this approach to taxation removes the focus from the traditional concept of an originating cause of the profit, and instead suggests that the taxation of income generated by e-commerce, where there is little human activity, ought to be based on the ultimate destination of the place of consumption, due to its close resemblance to a consumption tax like Value-Added Tax.[336] The application of this theory is lucrative for developing countries in that a large number of the consumers of international goods are resident in developing countries.

The adoption of a consumption based taxation system, however, has been argued to be contrary to the rationale of an international income taxation system as the latter is usually associated with *production* rather than consumption.[337] In response to this argument, Avi-Yonah[338] contends that the issue of which tax theory to use, be it income or consumption based, is an entirely different question to that of which jurisdiction should receive the revenues generated from business activities, i.e. the jurisdiction of its production or the jurisdiction of its consumption. In the circumstances, it is submitted that it is possible to allocate income tax revenues to jurisdictions in which consumption takes place, as it is likewise acceptable to allocate an origin-based Value-Added Tax to the country of production.[339]

5.5.3. MARKETS PROXY APPROACH

An alternative solution suggested to address the challenges posed by e-commerce is the "markets proxy" approach. The main proponent of this solution is Hoffart[340], who argues that although the contemporary international taxation system appears to emphasise the actual geographical location of buyers and sellers of tangible goods, the historical development of the permanent establishment concept shows

[335] Cockfield 1999 *Tul L Rev* 152.
[336] Oguttu and Tladi 2009 *Stell LR* 93.
[337] *Ibid*.
[338] RS Avi-Yonah *International Taxation of Electronic Commerce* (1997) 52 *Tax L Rev* 507 at 539.
[339] Oguttu and Tladi 2009 *Stell LR* 93.
[340] Hoffart 2007 *Nw J if Tech & Intell Prop* 106.

that the concept is not just concerned with the location of where the *value is created*, but also to where the *wealth originates*.

In contrast to the assumption that income from e-commerce should be allocated by consumption due to the fact that such a location is the place where the *value is created*, the argument postulated by Hoffart[341] is based on the fact that value production is not the only conceptual basis of the permanent establishment principle. Instead, Hoffart[342] submits that the traditional permanent establishment principle is based on an "access to markets proxy" premised on the assumption that the traditional tests based on physical presence were intended as a means of approximating a non-resident's *access to a host country's market.*

This argument is based on the premise that the early League of Nations documentation regarding the permanent establishment principle did not use the term “creation of value” but rather utilised the concept of the “origin of wealth”.[343] In this context, “origin of wealth” is considered to mean that all the stages that are involved up to the point at which a profit is realised are part of the origin of the profit, and accordingly Hoffart[344] submits that the permanent establishment principle, interpreted in this light, is sufficiently broad to allow the possibility that market access was a consideration at the time the rules were ordained.

Although only slightly different from the traditional value-oriented approach, Hoffart[345] submits that this small shift in a conceptual basis can be used to supplement the arguments for and against the revision of the permanent establishment rules. Hoffart[346] argues that the rise of the digital era has led to a situation where the creation of value, in the context of the "origin of wealth", could conceivably be achieved by automated software functions which may bear no relationship to geographic boundaries.

341 Hoffart 2007 *Nw J if Tech & Intell Prop* 117.
342 *Ibid*.
343 *Ibid*. Oguttu and Tladi 2009 *Stell LR* 92.
344 Hoffart 2007 *Nw J if Tech & Intell Prop 117*.
345 *Ibid*.
346 Hoffart 2007 *Nw J if Tech & Intell Prop* 118-119.

By adding the market access proxy approach to the debate surrounding the taxation of e-commerce, it is argued that it will ensure that tax policy developments will remain cognisant of the "real world norms and values"[347]. Although this may be helpful from a historical and theoretical standpoint, it is submitted that this theory does not take the debate further, nor does it propose a solution to the extant problems faced by the prevalence of e-commerce and the current formulation of the international taxation rules applying to e-commerce.

The conceptual shift, however, is of use when considering what country to allocate the profits to, as a solution with some basis in this theory could conceivably include the country in which the foreign enterprise is situated *and* the country in which the consumer is situated.

5.5.4. SELF-REGULATION

In light of the fact that the Internet is a decentralised network that is highly resistant to the traditional mechanisms used by governments to regulate the transfer of goods and services, there is a viewpoint that e-commerce should not be regulated by governments at all, but rather be subject to self-regulatory disciplines developed by Internet users.[348]

Johnson and Post[349] argue that the Internet, as a place, can develop its own effective legal authorities, but Oguttu[350] adamantly asserts that, although this theory may have application in respect of other laws, this cannot stand with regard to taxes. The reason for Oguttu's assertion is that governments ought not to abdicate their responsibility to collect tax revenues as it is the collection of those taxes that ensure that governments can provide goods and services to its inhabitants.[351]

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[347] Hoffart 2007 *Nw J if Tech & Intell Prop* 121.
[348] Johnson and Post 1996 *Stanford LR* 1367.
[349] Johnson and Post 1996 *Stanford LR* 1387.
[350] Oguttu 2008 *SA Merc LJ* 476.
[351] *Ibid*.

If one is to accept the government's inherent responsibility to collect taxes, it has been argued that it is therefore up to governments to transform the Internet so that it is capable of being regulated.[352] In other words, Lessing[353] suggests that governments should not attempt to force the adaptation of traditional and fundamentally static concepts underlying international taxation to fit the ever-evolving landscape of e-commerce but rather draw from the fluidity of the environment itself. Accordingly, this solution suggests the development of a legal taxation regime that is just as malleable as that which it seeks to regulate.

In light of the very fluid nature of e-commerce and the speed at which technology changes as contrasted against the slow process for a legislative change to become enforceable, it is submitted that a rigid change of laws is highly likely to become outdated before such a change could even be promulgated!

Although an attractive solution in theory, laws ought to be, by their very nature, certain and thus have a finite and determinable ambit, and the ambiguity in applying an unstable and changeable taxation regime would result in a myriad of its own administrative problems, whilst not necessarily addressing some of the key issues, such as the anonymity of the Internet, which *inter alia* make the current system unworkable.

Furthermore, even if such a theory were to be implemented, with sanctions being levied on those who do not conform, the enforceability of such sanctions would be virtually impossible to achieve by the South African revenue authorities in a foreign jurisdiction.

It is therefore submitted that such a proposal is, at best, a pipedream, and is unlikely to gain international acceptance due to the unstable nature of its determinative foundation and the inability to enforce any sanctions for non-compliance.

[352] L Lessig *Code and Other Laws of Cyberspace* (1999) 5-8.
[353] *Ibid*.

5.5.5. FORMULA TAXATION

Jinyan Li[354] argues that e-commerce is not the only issue in our global economy, but merely serves to expose the numerous difficulties inherent in modern society's move to increased globalisation. In light of these obstacles, she proposes a "formula taxation" theory[355] in which the jurisdiction to tax direct business profits is shared among the different countries involved in the transaction according to a set formula that takes into account all the relevant economic factors involved in the transaction and their relative importance in producing the income in question.[356]

This theory essentially provides that a business with operations in more than one country would be treated as one single taxable entity, but certain factors such as property, sales and the location of employees would determine how the profits that are generated by e-commerce transactions would be allocated among the different countries in which the business operates.[357]

At first glance, this solution appears to postulate a proposal that entails a fair distribution of the right to tax and would overcome several hurdles in relation to transfer pricing,[358] however, this argument has almost universally been rejected on the basis that it too ignores the basic features of e-commerce as a global, virtual and especially *anonymous* means to do business.[359] It is submitted that this approach only further exacerbates the extant problems in taxing e-commerce in that it does not actually address the practical problem of *how* to locate the places of e-commerce and the contributions of each country in relation to the production of the income in question, but only proposes a general and academic solution regarding how to apportion the right to tax between all the countries that may have had an involvement in the transaction, once these countries have been identified.

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354 J Li *International Taxation in the age of electronic commerce: a comparative study* 494.
355 J Li *International Taxation in the age of electronic commerce: a comparative study* 550.
356 Azam 2007 *Virg. Journal of Law and Technology* 14.
357 CE McLure Jr. "Taxation of Electronic Commerce: Economic Objectives, Technological Constraints, and Tax Laws" (1997) 52 *Tax L Rev* 269 at 419.
358 The transfer pricing rules that determine profit allocation are, however, beyond the scope of the current research.
359 Azam 2007 *Virg. Journal of Law and Technology* 14.

Furthermore, the application of this proposal creates an untenable situation in which transactions that are similar in economic nature to traditional commercial transactions, such as the sale of 'real' books, would be treated differently to their digital counterparts in that the latter would be subject to the formulary approach, whilst the former would still be taxed according to the extant principles of taxation.[360]

Although a formula based approach may answer the question as to how the right to tax will be shared amongst relevant countries, it is submitted that this argument offends the principle of neutrality and is unhelpful in addressing the fundamental issues faced in ascertaining which of these countries are to be used in the formula itself.

5.5.6. PERSONAL JURISDICTION

In 1996, the United States of America Department of the Treasury[361] argued that:

> *"[t]he growth of new communications technologies and electronic commerce will likely require that principles of residence based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible, to apply traditional concepts to link an item of income with a specific geographical location. Therefore, source based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere."*

The theory based on personal jurisdiction advocates a purely residence-based system of taxation in terms of which source countries would be unable to tax the profits generated by e-commerce transactions, even if a permanent establishment of a foreign company exists within its territorial borders and, in the absence of the

[360] Cockfield (1999) *Tul L Rev* 136.
[361] US Department of Treasure "Selected tax policy implications of global electronic commerce".

application of this theory, the income would have been taxable under traditional treaty or national law principles.[362]

This viewpoint is premised on feasibility considerations and therefore it is submitted that proponents of this theory are overly concerned with the fact that e-commerce transactions may escape taxation altogether. In so doing, however, the proponents of this theory disregard the complexities of territorial taxation by focusing solely on personal taxation as a means to levy tax on the resident's worldwide income, with no exceptions.[363]

Although *ex facie* an attractive option for first world countries, this proposal also does not address the anonymous nature of e-commerce and, coupled with the mobility of e-commerce businesses, the implementation of this theory is likely to result in an even higher propensity towards tax evasion as an e-commerce business can simply pursue the status of a resident in a low-tax or zero-tax country and thereby avoid taxation, even if the persons conducting the affairs of the company are situated elsewhere.[364]

This proposal is also inherently biased towards developed countries, which are the countries in which the majority of e-commerce businesses are based, whilst the developing countries, which are home to the consumers which allow the e-commerce businesses to thrive, do not receive any part of the revenue generated.

Understandably, such a proposal has lacked the necessary support from the rest of the world and accordingly, has never been more than theoretical conjecture.[365] This is abundantly clear in light of the fact that the theory has not been pursued any further for the better part of two decades.

[362] I Lejeune *et al* "Does cyber-commerce necessitate a revision of international tax concepts?" 38 *European Taxation – Amsterdam* 50 at 54-58. Cockfield (1999) *Tul L Rev* 148.
[363] Azam 2007 *Virg. Journal of Law and Technology* 15.
[364] *Ibid*.
[365] *Ibid*.

5.5.7. WITHHOLDING TAX

As elucidated above, e-commerce allows international enterprises to trade in foreign countries without establishing a permanent establishment in the traditional sense. Furthermore, the theories proposed in an attempt to address the challenges posed by e-commerce through the development of the permanent establishment principle are not reasonably capable of successful implementation. Accordingly, it is submitted that the authorities ought to consider alternatives to merely adapting the current definition and/or guidelines in respect of the permanent establishment principle to enable the taxation of business profits generated from e-commerce and consider the introduction of an entirely alternative solution not strictly based on an adaption of the current rules.[366]

In other words, when confronted with the wide array of difficulties that would be encountered with any development of the traditional permanent establishment definition, it is submitted that a reasonable conclusion to reach is that the concept is wholly inappropriate and does not have the requisite flexibility for adaptation to adequately contend with the technological developments that have effectively rendered the traditional concepts nugatory.

In the circumstances, it is submitted that the most viable option to prevent an erosion of the tax base is to abandon the ineffectual concept of a permanent establishment insofar as it relates to electronic commerce, and in its stead impose a withholding tax on the income of electronic enterprises.[367] This theory has its roots in the consumption theory discussed above, but takes the concept one step further. In this regard, the consumption theory postulates an answer to the question of *where* to levy the tax on e-commerce income, whereas the withholding tax postulates an answer to the question of *how* to levy such a tax.

It must, however, be noted that withholding taxes are not without their fair share of disapproval. As withholding taxes apply to cross-border sales of goods and

[366] Oguttu and Tladi 2009 *Stell LR* 93.
[367] See for example R Doernberg "Electronic Commerce and International Tax Sharing" (1998) 16 *Tax Notes International* 1013.

services that involve only foreign sellers and not local sellers, Pinto[368] has criticised withholding taxes as not being neutral.

A further criticism is that withholding taxes are often imposed on gross receipts, thereby negating the possibility of claiming any deductions, which could cause serious distortions where it is reasonably certain that a substantial part of the gross receipts consist of net income.[369]

It is possible that a withholding tax may also be considered to be a tariff, especially if it is not possible for a tax credit to be issued in the country of residence.[370] In this regard, it has been argued that a withholding tax levied in the source country would resemble more of an indirect consumption tax, as opposed to a direct income tax.[371] The inevitable consequence of this is the conflation of an income tax which generally focuses on where income is produced and a consumption tax which focuses on where consumption takes place.[372] As income taxes and consumption taxes are treated very differently in most circumstances, a reform of the international tax principles may have to follow should the lines between the true and the apparent nature of e-commerce profits begin to blur.

Furthermore, to obtain a refund of the amounts withheld, taxpayers would incur compliance costs associated with the filing of returns and reports, and the tax authorities would incur additional administrative costs to ensure that the system, as adopted, is enforceable.[373]

Most notably, the charging of a withholding tax on electronic commerce business profit would make the country doing so internationally uncompetitive, and there could potentially be some tax treaty constraints as neither the OECD Model Convention nor the United Nations Model Tax Treaty contain provisions catering for the imposition of a withholding tax on *active* business profits from source

[368] D Pinto "The need to Reconceptualize the Permanent Establishment Threshold" (2006) *Bull Int Fiscal Doc* 266 at 278. Oguttu and Tladi 2009 *Stell LR* 93.
[369] *Ibid*.
[370] *Ibid*.
[371] Cockfield 1999 *Tul L Rev* 152.
[372] Cockfield 1999 *Tul L Rev* 153.
[373] Oguttu and Tladi 2009 *Stell LR* 93.

countries, as they only contain provisions in respect of withholding taxes on *passive* income such as dividends, interest and royalties.[374]

In comparison to the challenges posed by the extant theories to develop the current permanent establishment concept, however, these concerns are not insurmountable. Pinto[375] suggests that to overcome and alleviate the disadvantages as outlined above, the withholding tax ought to be applied by source countries at a uniform rate to all active international e-commerce transactions. Furthermore, it is submitted that a withholding tax ought only to be imposed if e-commerce gross income surpasses a specified threshold within the source country[376] so as to avoid an unnecessary proliferation of taxes on e-commerce businesses with comparatively small commercial interaction with the source state.

In terms of implementation, Pinto[377] submits that such a withholding tax is imposed on the income of the e-commerce business at the ultimate destination of the goods and/or services purchased, and on the total of the *active* gross e-commerce sales above a certain minimum threshold, thereby excluding passive income which would continue to be governed under the existing rules. In other words, should a seller's total active gross sales in a jurisdiction remain below the minimum threshold, the withholding tax is refundable and the seller would not be subject to taxation in the source country, but would be required to file a return to obtain a refund of the amounts that have been withheld in the year of assessment.[378] If, however, the seller's total active gross sales exceed the minimum threshold, the seller would be subject to taxation in the source country in that the amounts withheld would not be refundable.[379]

Although Avi-Yonah[380] proposes that this rate be equal to the corporate income tax rate, the imposition of such a high rate in South Africa is likely to be considered by

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374 Oguttu and Tladi 2009 *Stell LR* 94. See further Articles 10, 11 and 12 respectively of the Organisation for Economic Co-operation and Development: *Model Tax Convention on Income and on Capital* (2008).
375 Pinto 2006 *Bull Int Fiscal Doc* 277-278.
376 Avi-Yonah 1997 *Tax L Rev* 545.
377 Pinto 2006 *Bull Int Fiscal Doc* 277.
378 Pinto 2006 *Bull Int Fiscal Doc* 278.
379 *Ibid*.
380 Avi-Yonah 1997 *Tax L Rev* 532-41.

the international community as being too burdensome, which would ultimately hinder the growth of the e-commerce industry in South Africa. Accordingly, it is submitted that a lower withholding tax is more likely to be effective.

To alleviate the disadvantages relating to the fact that withholding taxes are applied to gross profits, Pinto suggests that the filing of returns in source countries be based on a taxpayer's *net* income, and the tax withheld be creditable in residence countries to prevent it being viewed as a tariff.[381]

Notwithstanding the above, it is acknowledged that a withholding tax imposed on e-commerce profits may be criticised from a practical perspective due to the fact that the imposition of the tax would still result in administrative costs and the compliance costs will ultimately be placed upon the taxpayer who has to file returns to obtain a refund of the amounts withheld, and the tax administrators would still incur certain costs in ensuring the enforcement of such a system.[382]

It is submitted, however, that there will always be administrative costs in the imposition and enforcement of any solution adopted. A potential solution that is likely to be workable will be of considerable benefit due to the generation of large amounts of revenue that would otherwise go uncollected. Accordingly, the attendant administrative burden ought not to be viewed as a decisive hurdle in the adoption of a solution to the e-commerce challenges.

The application of a withholding tax eliminates the inherent difficulties in characterising income in the e-commerce context, instead of trying to manipulate the current taxation system to cater for the growth of e-commerce and concomitant obstacles as a result thereof.[383] Furthermore, the revenue authorities would be able to utilise advances in technology to assist them in ensuring that the system is operationally viable. Furthermore, the revenue authorities can unilaterally enact such a system, thereby overcoming the obstacle of revising the extensive and

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[381] Pinto 2006 *Bull Int Fiscal Doc* 278.
[382] Oguttu and Tladi 2009 *Stell LR* 94-95.
[383] *Ibid*

entrenched bilateral double taxation treaty network that exists between South Africa and other countries.[384]

Although this solution is not flawless, it is submitted that a withholding tax is the most feasible and practical solution to a difficult and diverse problem.

5.6. CONCLUSION

In light of the various challenges posed by e-commerce to the traditional concept of a permanent establishment, a number of proposals to address the shortcomings of the extant construction of the concept have preceded this thesis. Whilst each of these solutions has addressed certain challenges individually, no holistic solution that is reasonably capable of implementation has been proposed. Of the solutions already put forward, the imposition of a withholding tax is the most realistic, however, it is necessary to consider the imposition of this solution in the South African context in more detail than has previously been undertaken.

[384] Pinto 2006 *Bull Int Fiscal Doc* 278.

CHAPTER SIX

THE IMPOSITION OF A WITHHOLDING TAX AS A POSSIBLE SOLUTION FOR THE TAXATION OF E-COMMERCE IN SOUTH AFRICA

6.1. INTRODUCTORY REMARKS

As discussed more fully in chapter 5, the imposition of a withholding tax would serve to address and overcome many difficulties in the taxation of profits derived from a foreign entity in the e-commerce context. This chapter will explore the possibility of imposing a withholding tax on e-commerce proceeds in South Africa with reference to other withholding taxes that have been successfully implemented. Furthermore, this chapter will discuss how the withholding tax is to be implemented in practice, including a discussion regarding the distinction to be drawn between profits above and those below a pre-determined threshold, and the rate of tax to be imposed on qualifying income.

6.2. THE IMPOSITION OF A WITHHOLDING TAX IN SOUTH AFRICA

The concept of a withholding tax in South Africa is not unheard of. Essentially, a withholding tax, in the context of income derived by a non-resident in the Republic, is a mechanism by which the resident taxpayer will withhold the tax from the purchase price paid to the non-resident and pay it over to the tax authorities. The non-resident will then be required to submit records to the tax authorities in South Africa to claim any amounts which may be owing to it.

South African tax authorities have long since levied withholding taxes on both active and passive income in circumstances where there are difficulties in taxing the income derived by a non-resident from a source within the Republic.[385] For example, if a non-resident disposes of property that is situated within the borders of

[385] Oguttu and Tladi 2009 *Stell LR* 95.

South Africa, section 35A of the Income Tax Act ("the Act")[386] provides that the capital gains derived from this alienation are subject to a withholding tax of 5, 7.5 and 10 percent for natural persons, companies and trusts respectively. Furthermore, all amounts received by or accruing to foreign sportspersons and entertainers whilst in the country are also subject to a withholding tax of 15 percent by virtue of section 47B(1) read with section 47D of the Act. Section 35 of the Act imposes a withholding tax of 12 percent on royalties derived by a foreign entity from the utilisation of its property in the Republic, and more recently section 64G of the Act has effectively done away with the previous concept of a Secondary Tax on Companies and allows the tax authorities to levy a 15 percent withholding tax on dividends declared by companies.

The Electronic Communication and Transaction Act ("ECTA")[387] has already laid much of the groundwork that would enable the success of imposing a withholding tax on e-commerce profits in South Africa. The commonality between the profits that are the subject of extant withholding taxes, however, is that it is relatively simple to determine on *whom* to levy the tax, but the anonymity of the Internet still poses some difficulties in this regard.

In the circumstances, it is imperative that mechanisms are developed to enable the identification of parties and that such identification would at a minimum include standard online contact information, the trading name of the business and the statutory registration number of the enterprise.

It is submitted that the provisions of ECTA, if complied with and effectively enforced, will ease some of the identification problems posed by e-commerce.[388] For example, sections 23 to 25 of ECTA require the disclosure of the time and place of the communication, dispatch and receipt of information and govern the attribution of data messages to the originator. There are also provisions dealing with the authentication of products and services (section 38 of ECTA), the integrity and reliability of Internet data (sections 27 and 30 of ECTA), the display of

[386] Act 58 of 1962.
[387] Act 25 of 2002.
[388] Oguttu and Tladi 2009 *Stell LR* 96

information about the supplier of electronic goods and services on the website (section 42 and 43 of ECTA) and the appointment of cyber inspectors with the power to inspect any website activity and information (sections 80 and 81 of ECTA).

Regarding the practical implementation of a withholding tax in South Africa on the proceeds earned as a result of e-commerce transactions where the consumer resides within the borders of the Republic, it is submitted that a number of rules ought to be put in place to ensure that South African Revenue Service can effectively levy such a withholding tax, notwithstanding the absence of a permanent establishment of a foreign enterprise. This legal framework would thus include rules relating to (1) profits below a pre-determined threshold; (2) profits above a pre-determined threshold; and (3) the rate of tax to be imposed.

6.3. PROFITS BELOW A PRE-DETERMINED THRESHOLD

One of the predominant issues regarding the taxation of ever increasing e-commerce transactions is the administrative burden incurred in monitoring and characterising such income.[389]

In an effort to relieve these administrative hurdles, it has been suggested that a provision ought to be created within the current model tax treaties that imposes a distinction between active and passive income.[390] In respect of *passive* income such as royalties, services, sales of business inputs or rental income, it is suggested that the country of residence alone would have the right to levy tax on the income, provided the income is not earned through a permanent establishment situated in the source country.[391] This means that insofar as the traditional permanent establishment rules find application in respect of physical, fixed places of business, they will continue to apply. This solution is therefore merely designed as a parallel solution to cater for circumstances where the traditional permanent establishment principles are ineffective.

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[389] Cockfield 1999 *Tul L Rev* 151.

[390] RS Avi-Yonah *The Structure of International Taxation: A Proposal for Simplification* (1996) 74 *Tex L Rev* 1301 at 1308-10.

[391] *Ibid.*

Under this parallel solution, it would not matter how much income is generated in the source country, if the income is passive income, it will be taxed in the country of residence of the business.

On the other hand, in respect of *active* income, it is suggested that all cross-border transfers of e-commerce goods, services and capital that generate active income below a pre-determined threshold are taxed in the country of residence. However, if the activities generate active income that exceeds the threshold, the income so generated ought to be deemed to be proceeds generated within the source country.[392]

For ease of reference, this solution can be represented in the graph below:

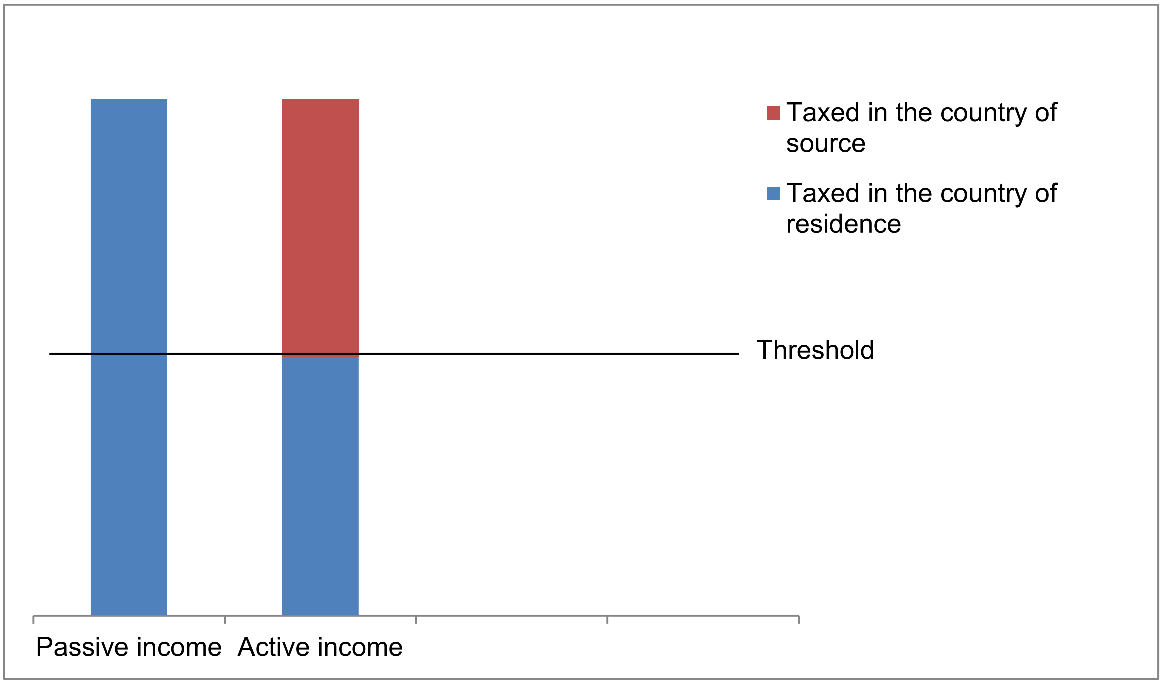

Fig 1. Graphical representation of the proposed solution

The threshold itself would be pre-determined and subject to change depending on the inflation rate and what is considered to denote *significant* business activity. In other words, the international enterprise will ordinarily be liable for tax in its country of residence, however, if its active income in South Africa surpasses the pre-

[392] *Ibid.*

determined threshold, it will be considered to be conducting substantial business activity in the Republic and therefore liable to pay tax in South Africa as the source country.[393]

The rationale behind the imposition of a threshold is similar to the notion that a permanent establishment is evidence of significant business operations in the source country, but instead of basing the assumption regarding business activities on a physical presence the assumption is based on the amount of revenue generated.[394] Accordingly, should a foreign enterprise not earn income above the pre-determined threshold, it shall not be considered to be conducting significant business in South Africa and therefore not liable to the South African revenue authorities for tax.

Furthermore, it is submitted that any payment from a consumer in a source country for e-commerce goods or services from a foreign company would not be subject to any source-country withholding tax for below threshold sales, unless the income gives rise to passive investment income, in which case the extant rules relating to passive investment income will continue to apply.[395]

The imposition of such a threshold would have the effect of significantly reducing the monitoring costs and administrative burden associated with implementing this solution. From the enterprise's perspective, the fact that revenue generated below a certain threshold is taxed in its country of residence would also greatly reduce the compliance costs for small and medium sized e-commerce businesses as such businesses would not be required to seek a foreign tax credit for any foreign withholding taxes paid, or file a tax return in jurisdictions in which the enterprise has had meagre business dealings.

The proposal to tax e-commerce transactions mainly on a residence-based basis would significantly reduce compliance costs and ensure that the growth of e-commerce is not stunted as it would alleviate the need for most e-commerce

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393 Cockfield 1999 *Tul L Rev* 151.

394 Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle (Series of International Taxation)* 78.

395 Cockfield 1999 *Tul L Rev* 151.

companies to file income tax returns in the source country. It would also negate the need for the foreign enterprise to have foreign taxpayer identification numbers, provide financial data, and the like, simply because source-country consumers have purchased their goods and services.

6.4. PROFITS ABOVE A PRE-DETERMINED THRESHOLD

It follows, therefore, that any e-commerce transactions that generate income above the pre-determined threshold would then be subject to a source withholding tax that could conceivably be negotiated separately within the specific tax treaties.[396]

Although this proposal is similar to the theory developed by Doernberg,[397] this proposition differs in certain key respects, the most significant of which is that it is suggested that the tax be imposed on the total amount of the payment to the resident company, instead of the net amount as postulated by Doernberg, and as such the effective withholding tax rate may be significantly higher than the effective rate in respect of the same transaction.[398] Furthermore, unlike Doernberg's suggestion, the withholding tax would be applied irrespective of whether a permanent establishment exists in the source country.[399]

It must, however, be noted that for such a system to work, it requires international acceptance and countries are generally loathe to permit an additional tax being applied to e-commerce business profits.[400] In order to avoid inequitable double taxation, the resident company must be able to receive credit for the withholding taxes to be applied to offset any resident state taxes that may be owed on the same transaction.[401]

For the sake of completeness, it is noted that the imposition of the above system of a withholding tax on active e-commerce proceeds above a pre-determined

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[396] Cockfield 1999 *Tul L Rev* 162.
[397] Doernberg 1998 *Tax Notes International* 1015-1016.
[398] Cockfield 1999 *Tul L Rev* 162.
[399] *Ibid.*
[400] *Ibid*.
[401] Articles 10-12 of the Organisation for Economic Co-operation and Development: *Model Tax Convention on Income and on Capital* (2008).

threshold may not cure the problem of enforcement as it will still be difficult to identify the consumers and ensure they withhold and remit the proper amount to the South African Revenue Service.[402] In addition, it will also be difficult to determine when the threshold has been exceeded in respect of direct consumer transactions.[403]

Notwithstanding the above, the imposition of penalties upon those South African taxpayers who do not comply with the rules relating to the submission of taxes withheld could prove to be an effective means of circumventing this issue. Although not entirely fool proof, it is submitted that it is far easier for the Revenue authorities to penalise non-compliant South African residents, as opposed to levying sanctions on non-compliant foreign entities.

6.5. THE RATE OF TAX IMPOSED

As previously discussed, withholding taxes do not provide a solution to every problem regarding the taxation of problematic income and the concept finds much opposition. Most notably, withholding taxes in the context of e-commerce have been criticised for impeding cross-border trade and investment due to several factors, including the potential for double taxation if the withholding tax is not creditable against or exceeds domestic tax; the creation of additional compliance costs for the foreign entity in the source country; the need for the creation of additional tax rules to ensure the enforcement of such a tax in the source country; and the waste of resources by foreign enterprises in attempting to avoid the withholding tax.

It is, however, submitted that, when faced with the various hurdles posed by every other solution proposed, the imposition of a withholding tax, although not a perfect solution, is the option with the problems that are the most surmountable. Once consensus has been reached that a withholding tax ought to be levied by the source country on the proceeds of active income above a pre-determined

402 Cockfield 1999 *Tul L Rev* 163.
403 *Ibid*.

threshold, the question then arises as to what rate the withholding tax ought to be charged.

In this regard, Doernberg[404] suggests that a 10% rate may be reasonable to ensure that source countries are properly compensated for the erosion of their tax base due to the growth of e-commerce. Although a 10% withholding tax may *ex facie* appear to be reasonable, it is submitted by Cockfield[405] that international consensus and negotiation are not the only important factors to be considered and one must also consider the appropriateness of the rate of taxation from a practical perspective. Furthermore, there has been a global trend away from the imposition of withholding taxes due to the increased emphasis on the liberalisation of trade and investment amongst countries.[406] In the circumstances, Cockfield purports that a 10% withholding tax as suggested by Doernberg may prove to be too high and thus some of the problems outlined above could be alleviated if the rate is reduced.[407]

It is in this context that Cockfield submits that an appropriate withholding tax rate would be 5%, as such a rate would alleviate the double taxation risk, reduce the compliance costs associated with the obtaining of a tax refund in a source country, facilitate the enforcement of compliance, and it is unlikely that foreign companies would expend resources on extensive tax planning strategies to circumvent such a low withholding tax rate.[408]

Whilst the 5% solution advanced by Cockfield may be low enough to cure some of the impediments to international acceptance, the adoption of such a low rate of tax may not be enough to counteract the administrative cost burden associated with monitoring and collecting such taxes and ensuring compliance with the taxation obligations.

[404] Doernberg 1998 *Tax Notes International* 1015.
[405] Cockfield 1999 *Tul L Rev* 164.
[406] *Ibid*.
[407] *Ibid*.
[408] *Ibid*.

It is respectfully submitted that the decision regarding what rate of taxation to apply cannot be viewed in isolation and must be considered together with the threshold to be applied to active taxes. In this regard, it is submitted that the higher the threshold imposed, the higher the withholding tax rate can be. Should a higher rate of tax be imposed on a smaller number of businesses, it is submitted that the taxes collected would still be worthwhile in that more revenue contributions will be sought from fewer entities, rather than attempting to enforce the compliance of many entities for very little on each transaction. This would also have the effect of easing the administrative burden of the revenue authorities in that fewer entities would be obliged to comply.

It is therefore submitted that the pre-determined threshold ought to be such that only major global traders are caught within its ambit, such as Amazon.com, Apple Inc., Netflix Inc., Sony Electronics Inc. and the like. The fact that entities of this ilk have extensive commercial dealings in almost every corner of the world, as well as the sheer magnitude of these dealings, will further assist the revenue authorities in identifying each entity and ensuring that the entities comply with their taxation obligations.

It is suggested that the rate of tax to be imposed in this context ought to be a flat rate of between 10 and 12%, such rate to serve as a starting point to ensure a minimum standard of uniformity amongst all jurisdictions, and which can be further negotiated on a bilateral basis between certain countries, if desired. A taxation rate of between 10 and 12 percent will also ensure that the South African economy is adequately compensated for the loss of locally generated profits and the concomitant erosion of the local tax base.

This suggestion is bound to be criticised as being a disincentive to foreign trade, however, it is submitted that South Africa has a vast consumer base which the first world is eager to access, and multinational e-commerce corporations will thus be willing to expend the necessary cost of a withholding tax in order to continue doing business in the Republic.

6.6. CONCLUSION

It is submitted that the imposition of a withholding tax is the most appropriate means to tax e-commerce profits in an emerging economy such as South Africa. This theory, based in the consumption theory discussed in the previous chapter, provides a means to levy tax on e-commerce proceeds. In order to reduce the administrative burden of enforcing such a tax, it is submitted that the withholding tax ought only to be imposed on active e-commerce income that exceeds a specified threshold of between 10 and 12 percent. This solution is thus designed as a parallel solution to cater for circumstances where the traditional permanent establishment principles are ineffective.

CHAPTER SEVEN

CONCLUSION

7.1. THE GOAL OF THE RESEARCH

The goal of the research undertaken was twofold. The first leg of the research entailed an analysis of the effect of the increasing popularity of e-commerce on the South African legislative framework, particularly in relation to the taxation of foreign entities performing substantial business activities within the Republic. The second leg of the research involved drawing on previous attempts to address the challenges posed by e-commerce and formulating a proposal for a solution to the question regarding how to tax e-commerce profits earned by a foreign entity in South Africa.

In the circumstances, the research considered whether the extant legislative framework provides an appropriate basis for the development of the rules governing this area of law, or whether an entirely new basis for the taxation of such profits ought to be considered.

7.2. HOW THE GOAL OF THE RESEARCH WAS ACHIEVED

The tax rules relating to source income are well-established and provide that, in order to tax a person (whether natural or juristic) on any amount, there must be a connection between the country wishing to levy such tax and the amount to be taxed. In the case of foreign persons and entities, that connecting factor is that the income must originate from a source within the Republic.

Furthermore, in order to foster international trade and avoid the practical difficulties associated with the possibility of double taxation in circumstances where a foreign entity may earn income from a source in South Africa, and therefore be liable for tax in both South Africa and its country of residence, South Africa has entered into a number of double tax agreements to effectively regulate the way in which the two jurisdictions will share or allocate the right to tax the income of the non-resident multi-national enterprise.

Against the background of the settled law in relation to the taxation of foreign entities in respect of profits generated from a source within the Republic, the research explored the proposition that e-commerce, as a means by which to do business, has become overwhelmingly popular at an unprecedented rate of development. The Internet, once a complex system of networks accessible to only a small number of people with the skills necessary to operate its processes, has now become a commonplace platform for communication, research, recreation, advertising and trading, and is permanently accessible from many homes, businesses and on personal mobile devices and tablets.

Whilst a feat of profound technological advancement, the very nature of the trading platform being intangible means that e-commerce enables persons to trade instantaneously and efficiently without being confined by traditional geographical boundaries. Therefore, e-commerce is, by its very nature, highly mobile and global in its ambit and consequently, is inherently anonymous.

In light of the above defining characteristics of e-commerce, the rapid escalation of e-commerce businesses as well as traditional businesses utilising the benefits of e-commerce in additional to their ordinary business practices, has led to concerns regarding the continued applicability of source-based taxation laws which are dependent upon a fixed place of business for their application. In other words, the overall effect of the non-geographical existence of e-commerce is that it makes it exceedingly difficult to establish international norms for identifying the source of a taxpayer's income.

One of the most prevalent source-based taxation laws is the application of the concept of a "permanent establishment", which is often utilised in double tax agreements concluded between South Africa and foreign jurisdictions and utilised as a means to attribute business profits to a taxing authority. In this context, a "permanent establishment" being defined in terms of Article 5(1) of the Organisation for Economic Co-operation and Development Model Tax Convention

("OECD Model Convention") as a “fixed place of business through which the business of an enterprise is wholly or partly carried on”, is used as the mechanism by which a taxing right is allocated to a specific jurisdiction. The concept is thus significant in that the existence of a permanent establishment allows the country in which the establishment is situated, i.e. the source country, to tax its income, regardless of the fact that the permanent establishment may not have a separate legal existence as a resident in the Republic.

Against this milieu, it is noted that the development of the Internet has allowed online retailers to accomplish much of their sales and advertising strategies via a website that allows direct interaction with the customer and transfers such transaction costs to customers, thus eliminating the need for a physical intermediary in the source state. Furthermore, customers may purchase commodities or gain access to services without ever having to leave the comfort of their own homes, which has enabled international corporations to centralise many of their operations in one jurisdiction, usually the country in which it is registered, despite conducting significant business in a multitude of foreign countries. As a result of an international company’s ability to shift part of its operations from traditional permanent establishments, as defined, to the Internet and facilitate significant business transactions electronically, it is submitted that there is great potential for a reduction of the amount of income that may be attributable to an international company in a foreign country.

Having achieved the first goal of analysing the effect of e-commerce on the traditional legislative framework governing the taxation of non-resident enterprises, the second goal of the research was to propose a possible solution for the taxation of e-commerce, taking into account previous attempts to address the challenges posed by e-commerce.

In an effort to address the challenges posed to the traditional permanent establishment principle by the advent of e-commerce, the Organisation for Economic Co-operation and Development ("OECD") has developed certain guidelines which have adapted traditional principles to deal with the current technological climate. It is submitted, however, that these guidelines are impractical and the solution provided only serves as an artificial means of addressing the problems associated with the taxation of e-commerce, whilst ignoring the practical realities.

In addition to the solution proposed by the OECD, taxation strategists and academics alike have also proposed a myriad of other possible solutions, such as the construction of a virtual permanent establishment by way of a fiction, or the ideological shift in understanding as advocated by the markets proxy approach. There are suggestions premised on fluidity such as the "self-regulation" theory that recommends that e-commerce should not be regulated by governments at all, but rather be subject to self-regulatory disciplines developed by Internet users, and highly rigid theories such as the formula taxation approach. These contradictions in the basis of theories are rife, such as one suggestion being that a purely residence-based system of taxation be utilised, whereas another suggestion is premised on the idea that there should be a consumption tax in the country of source.

It is submitted that each of these theories has merit and a certain degree of appeal in its own right, however, none have obtained universal acceptance and application due to the fact that no single theory adequately addresses all the concerns raised by e-commerce.

Having considered the relative advantages and disadvantages of each approach, it is submitted that due to the fact that e-commerce allows international enterprises to trade in source countries without establishing a permanent establishment in the traditional sense, the extant legislative framework is wholly inappropriate as a basis for the development of the rules governing this area of law. Therefore, it is submitted that the authorities ought to consider alternatives to merely adapting the current definition and/or guidelines in respect of the permanent establishment principle to enable the taxation of business profits generated from e-commerce and consider the introduction of an entirely alternative solution not strictly based on an adaption of the current rules.

In this context, a withholding tax is the most appropriate means to tax e-commerce in an emerging economy such as South Africa. This theory has its roots in the consumption theory but takes the concept one step further. In this regard, the consumption theory postulates an answer to the question of *where* to levy the tax on e-commerce income, whereas the withholding tax postulates an answer to the question of *how* to levy such a tax.

Although a withholding tax has its own disadvantages, in comparison to the challenges posed by previous attempts to develop the current permanent establishment concept, these concerns are not insurmountable. In order to avoid an unnecessary proliferation of taxes on e-commerce businesses with comparatively small commercial interaction with the source state, it is submitted that the withholding tax ought to only be imposed if active e-commerce gross income surpasses a specified threshold within South Africa.

In other words, the proposal submitted is that, in order to relieve administrative hurdles, only *active* business profits would be taxable in terms of a withholding tax. In respect of passive income such as royalties, services, sales of business inputs or rental income, it is suggested that the country of residence alone would have the right to levy tax on the income, provided the income is not earned through a permanent establishment situated in the source country. This means that insofar as the traditional permanent establishment rules find application in respect of physical, fixed places of business, they will continue to apply.

The solution proposed in this thesis is therefore merely designed as a parallel solution to cater for circumstances where the traditional permanent establishment principles are ineffective. These circumstances are specifically in relation to active income above a pre-determined threshold.

The threshold itself would be pre-determined and subject to change depending on the inflation rate and what is considered to denote *significant* business activity. It is furthermore submitted that this threshold ought to be fairly high so as to include only major global traders with a significant online presence. This would also have the effect of easing the administrative burden of the revenue authorities in that fewer entities would be obliged to comply.

The active profits above this threshold would then be subject to a 10 to 12% withholding tax. This tax rate may also serve as a starting point to ensure a minimum standard of uniformity amongst all jurisdictions, and which can be further negotiated on a bilateral basis between certain countries, if desired. Although seemingly high, it is submitted that foreign enterprises seeking to gain access to the emerging economy in South Africa will be willing to submit to such an expense which will, in turn, ensure that the South African economy is adequately compensated for the erosion of the local tax base.

7.3. LIMITATIONS OF THE RESEARCH AND IDENTIFICATION OF AREAS FOR FURTHER RESEARCH

The research undertaken utilised an interpretative research methodology to critically analyse documentary data, and was conducted in the form of an extended argument, supported by such documentary evidence.

In the circumstances, no independent field work research was undertaken. In this regard, data relating to the growth of e-commerce in South Africa is scant and with the exponential rate at which technology develops, presumably outdated and/or largely irrelevant for the purposes of this thesis. It was therefore necessary to draw conclusions regarding the growth of e-commerce in South Africa from data relating to the growth of e-commerce on a global scale and, in particular, other emerging economies such as Brazil, Russia, India and China.

Furthermore, the ambit of this research was confined to a discussion of the narrow concept of a permanent establishment. Although certain provisions of double tax agreements have been discussed insofar as such discussion was applicable to the research at hand, further research could be undertaken regarding the attribution of business profits in terms of Article 7 of the OECD Model Tax Convention.

Lastly, with regard to the solution proposed to address the challenges posed by e-commerce to the permanent establishment concept, additional research could be undertaken to explore the interaction between a withholding tax as suggested and import duties and other related taxes.

As e-commerce continues to grow, potentially eroding the tax base in South Africa, a workable solution to the problem becomes ever more urgent. This research has recommended one potential mechanism to capture the proceeds of e-commerce within the tax net.