LEARNING UNIT : 08

CHAPTER 6

Income tax and e-commerce

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6.1 INTRODUCTION

The globalisation of trade in recent years has escalated to new heights since the introduction of e-commerce, which enables entities to trade worldwide at the mere click of a button. Where there is trade there is always the possibility of levying tax. This possibility is significantly complicated by electronic systems where many transactions are completed simultaneously by many individuals on the internet from locations that are often difficult to trace and by individuals who are difficult to identify.

The basic jurisdictional principles of most tax law systems such as residence and source are disguised by the complications of electronic transactions, often leaving the States that would normally have benefited from the taxation of these transactions out of pocket (Fitzgerald, Middleton, Lim & Beale 2007: 573).

Tax authorities worldwide are forced to adapt their application of existing tax laws in order to catch the vast variety of electronic transactions within their net of taxation. It is essential for such tax authorities to keep up with the technological developments of trade. It is also only fair for electronic traders to be subjected to exactly the same type of taxes and amounts as their more traditional offline counterparts (Fitzgerald *et al.* 2007: 573). This poses certain challenges to tax authorities as far as the collection of taxes and the enforcement of tax laws is concerned. Innovative methods of detecting trade must be devised, alongside legislation which enables the particular tax to be levied in the first instance.

Similarly, South African taxpayers and their international trade partners should be aware of the tax consequences of their online activities. Ignorance of the tax rules for e-commerce could lead to a very unwelcome increase in the taxes that are paid by such traders, sometimes even in States which they did not perceive as being involved in their specific transaction (Buys & Cronjé 2004: 295).

This chapter will analyse the taxation of e-commerce from a South African tax law perspective. This will be done by explaining the legal basis for income tax, identifying the problem areas, explaining how the problems have been addressed internationally and suggesting ways in which the South African system can be improved. Although this chapter will focus on the issues that arise when levying income tax, it is still possible for e-commerce to give rise to liability for capital gains tax (which is in essence a part of income tax), donations tax and certain withholding taxes that are

1 For example, the withholding tax on royalties provided for in Section 35 and the withholding tax on entertainers in Section 37A of the Income Tax Act 58 of 1962 (hereafter referred to as the Income Tax Act).

also provided for in the Income Tax Act 58 of 1962.[1] This discussion is, however, confined to income tax only and will not discuss all the types of taxes that could be levied by the South African tax system.

6.2 THE LEGAL BASIS FOR LEVYING INCOME TAX (JURISDICTION)

All individuals worldwide are taxed on the basis of residence and source. South Africa follows a residence-based system of taxation, which means that an individual who is resident in South Africa will be taxed on worldwide income. Non-residents are, however, taxable in South Africa if they have earned income from a South African source. Alternatively, if a State enforces a source-based system of taxation, the individual will be taxed by the State in which the income is earned. It is also possible to use both a residence-based and a source-based system within one specific jurisdiction (Meyerowitz 2007: par. 7.1).

The internationalisation of the working arena, especially in the context of e-commerce, has created all kinds of cross-border jurisdictional problems for the levying of income tax. In order to determine how a natural person or other entity will be taxed, regard must be given to the specific system which applies in the country in which the person resides and participates in trade or e-commerce. The question should be asked whether a residence-based or source-based or combined system applies in each of the States and how the interaction between the two systems is regulated. One should also try to avoid a situation in which a person is taxed twice on the same income (also known as international double taxation).[2 3]

International double taxation can, however, be avoided through national laws (which usually provide for a tax credit system, exemption or deduction for foreign taxes paid) or the conclusion of a double tax agreement between two States (Olivier & Honiball 2008: 4).[4] Cross-border transactions, the globalisation of services and the participation in trade on the internet therefore always carry a risk of international double taxation for the individual or entity concerned (Meyerowitz 2007: par. 7.2; Olivier & Honiball 2008: 3). These types of transaction also carry the risk for the particular revenue service (or even multiple authorities) of taxpayers escaping the tax net and not being taxed at all.

The dilemma created by e-commerce is certainly no exception to other types of commerce as it is not always possible to determine which State has jurisdiction to tax a specific transaction. Similarly a multitude of States could be involved in one transaction which makes apportionment of the tax liability problematic.

A person could thus work and trade in a State which levies tax on income earned within its territory, thus following a source-based system, or the same person could be resident in a country which levies income tax on his worldwide income, including the amount earned in the first State because it follows the residence-based system (Meyerowitz 2007: par. 7.2; Olivier & Honiball 2008: 3). The same individual could then transact on the internet with other parties resident in a third State, which could then have their website hosted by a server in a fourth State – all of these states could have different systems of taxation.

Davis (2002: 162) illustrates this well by the use of an example in the context of a juristic entity, in this case a French company which supplies food and wine internationally. This company makes use of an internet site hosted by a server situated in the US, but the management and administration of the business is done mainly in France. The import and export department of the business is situated in Hong Kong where the webpages are designed and the produce is dispatched to international clients in a variety of different States.

While it is not possible to keep up to date with all legal systems that apply globally, knowledge of the South African system is imperative for residents and all parties who intend being involved in activities which generate income inside South Africa's borders, coupled with a working knowledge of the international instruments which can assist in

2 Olivier and Honiball (2008). International double taxation occurs when income tax is levied by two or more States on the same amount in respect of the same period.

3 See Olivier and Honiball (2008:4), where the writers distinguish between juridical and economical double taxation. Juridical double taxation occurs when a taxpayer is taxed on exactly the same income in two different States, and economical double taxation occurs when two different taxpayers are taxed on the same income by two different States. The discussion in this chapter concentrates on juridical double taxation.

4 This chapter concentrates on the use of international double tax treaties and the OECD Model Tax Convention as a relief from juridical double taxation. See discussion in par. 6.6.

solving cross-border jurisdictional income tax problems.

6.3 THE BASIC PRINCIPLES OF SOUTH AFRICAN INCOME TAX LEGISLATION

6.3.1 *Introduction*

In South Africa a person is taxed if the amounts that they earned form part of their taxable income for a particular year of assessment (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks, De Swart & Jordaan, 2010: 2). Income tax is also generally referred to as normal tax and is levied on all types of persons whether natural or juristic (Stiglingh *et al.* 2010: 1). In order to simplify the discussions that follow, this chapter will be confined to natural persons[5] and companies[6] as defined in the Income Tax Act.

The starting point to determine a person or company's taxable income is firstly to decide whether or not an amount falls within the definition of gross income. Secondly, certain amounts that are received by, or that accrue to, a taxpayer will be exempt and therefore subtracted from gross income, and thirdly certain amounts paid or losses incurred may be deducted from the amounts received (Stiglingh *et al.* 2010: 4–5).[7] This is an over-simplification of a very complex system, but it should be sufficient to explain the principles that apply to e-commerce transactions. Once all the principles of these three basic steps are adhered to under the Income Tax Act, the taxable income is determined, from which further rebates may be deducted and the tax rate as provided for in the annual tax tables is then applied to the result of such calculations (Stiglingh *et al.* 2010: 4).

6.3.2 *Gross income*

The basic starting point is the determination of a taxpayer's gross income. The term "gross income" is defined in Section 1 of the Income Tax Act:

> "[G]ross income" in relation to any year or period of assessment, means –
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic, during such year or period of assessment, excluding receipts or accruals of a capital nature.

The definition then goes further to list specific situations where amounts, which do not technically comply with the general part of the definition of gross income, will be included in gross income regardless of such technical non-compliance (Section 1(a)–(n) of Income Tax Act).[8]

From this definition it is clear that in South Africa residents are taxed on the basis of their residency in the country and non-residents are taxed on a source basis. A closer scrutiny of the elements of this definition is therefore essential to determine whether or not a specific person involved in e-commerce within South Africa's borders will be subject to income tax.[9]

6.3.2.1 The total amount in cash or otherwise

The total amount in cash or otherwise refers to the fact that any amount which a taxpayer receives or which accrues must be either money or, as decided in *Lategan v CIR*, it must have monetary value. In *CIR v Delfos* the court stated that an amount which cannot be converted into money cannot be classified

5 Section 1 of the Income Tax Act defines the term "person" to include an insolvent estate, the estate of a deceased person, any trust and any portfolio of a collective investment scheme.

6 Section 1 of the Income Tax Act defines the term "company" very widely and includes companies incorporated in terms of South African law as well as entities or corporations incorporated in terms of the law of any other country. The definition further includes close corporations, associations, cooperatives and collective investment schemes under certain circumstances.

7 See the detailed explanation of the calculation of taxable income and the eventual tax liability. In this chapter the essential concepts are highlighted so that readers are able to understand the impact of e-commerce on income tax law.

8 Definition of gross income, par. (a)–(n) of Section 1 of the Income Tax Act.

9 For ease of reference, the circumstances described in the definition that applies to both residents and non-residents will be discussed first, followed by the legal principles that apply specifically to each resident or non-resident taxpayer. As discussed, they form the cornerstone of the jurisdictional dilemma applying tax laws to e-commerce.

as income. When a taxpayer receives an amount which is not cash, the basic rule is that the market value of this receipt will be included as at the date of the accrual.[10] These rules apply equally whether the taxpayer is resident in South Africa or not.

When it comes to e-commerce it is often difficult for the South African Revenue Service (SARS) to trace the transaction that was done online by a resident or to place a monetary value on certain goods bought.

6.3.2.2 Received by, accrued to or in favour of

For a taxpayer to be subject to income tax in South Africa, there has to be either a receipt or an accrual of an amount (Stiglingh *et al.* 2010: 16).[11] Income tax will be levied at the earlier of the two events,[12] in other words whichever occurs first, as it is possible for receipt to take place in one year and accrual in another tax year.[13]

Since this phrase is not defined in the Income Tax Act, it has been the subject of many court cases which we look to for assistance in its interpretation.[14] One of the most recent cases is that of *MP Finance Group CC v CSARS* where the court found that a taxpayer will "receive" an amount in circumstances where the taxpayer had the intention to receive such an amount for her or his own benefit.[15]

By contrast, the term "accrual" is not reliant on the intention of the taxpayer, but must be resolved by investigating the law that applies in each specific factual instance to determine whether or not the taxpayer had become unconditionally entitled to an amount.[16]

In the context of e-commerce, the physical receipt of amounts is often established by means of credit card payments. The details of these transactions are mostly on secure internet sites which are not accessible to the general public or SARS. This compounds the practical problems that may arise due to the inability of the revenue services to trace monetary receipts by taxpayers. It is difficult to trace whether the consumer is resident or not, and although there might be evidence of the transaction on the internet, the secure payment sites make it difficult to link the payments to the correct taxpayer or correct transaction.

It is even more difficult to trace whether or not an amount accrued to a person as can be seen in the example of a taxpayer who orders a book online with a date of delivery agreed on. In a legal sense such a taxpayer is only entitled to claim payment once the book is delivered. If the order is cancelled meanwhile, then no accrual of the purchase price occurs because the taxpayer is not unconditionally entitled to it. The sheer volumes of transactions and the identification of the taxpayer are once again problematic. Although full payment is usually required prior to the product being delivered, this is not traceable, giving endless possibilities for fraud and tax evasion.

6.3.2.3 Excluding receipts of a capital nature

Once again reference to case law is necessary to determine whether or not an amount will be included or excluded for gross income purposes. Although a capital gain (or loss) is included in taxable income in terms of the 8th Schedule to the Income Tax Act, the rate at which it is effectively taxed is much lower than it would be if it were included in the gross income calculation (Stiglingh *et al.* 2010: 26).

The courts have developed many guidelines to determine whether or not an amount received by a taxpayer is of a capital or income nature, the most

10 *Cf.* Stiglingh *et al.* (2010: 14-15); *CIR v Butcher Bros (Pty) Ltd* at 304; *Lace Proprietary Mines Ltd v CIR* at 280; *CSARS v Brummeria Renaissance (Pty) Ltd.* An interesting decision was reached in *CIR v Butcher Bros (Pty) Ltd*, when it was decided that the value of improvements that were added to a property by a tenant could not be determined, and as a result excluded this value from gross income.

11 Definition of "gross income" Section 1 of Income Tax Act.

12 Stiglingh *et al.* (2010: 20); *SIR v Silverglen Investments (Pty) Ltd* at 377.

13 *CIR v Delfos* at 252.

14 *Geldenhuys v CIR; CIR v Genn & Co. (Pty) Ltd*, to name but a few.

15 Although this was decided in the context of illegal amounts, this decision confirmed an important principle in the general application of the term "received by or accrued to" as was already found in the *Geldenhuys* decision (supra n 34), namely that receipt for the use and benefit of the taxpayer was required for an amount to be taxable.

16 *Lategan v CIR* at 209; *CIR v Delfos* at 251; *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* at 364; *Mooi v CIR* at 684. *Cf.* Stiglingh *et al.* (2010: 18–20).

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important of which is the enquiry to determine the intention of the taxpayer. If a taxpayer had the intention to be involved in a "scheme of profit making", then the amount will be income in nature.[17] Many other factors are taken into account when determining this intention, such as the frequency of transactions, profession of the taxpayer, the taxpayer's *ipse dixit* (what he states his intention to be), the history of the asset, whether there was continuity in the activities that the taxpayer was involved in and more (Stiglingh *et al.* 2010: 25–37). A taxpayer is also entitled to realise a capital asset at its best possible value[18] and each set of circumstances must be judged on its own merits to ascertain whether or not the taxpayer did something more[19] which changed the intention of the taxpayer to an intention to generate profit.[20]

The intention of a company is determined by judging the actions of the organs through which it functions, such as the minutes of meetings, actions of directors or managers of the company with reference to the statement describing the purposes or scope of business of the specific company as contained in the memorandum of association.[21] The purpose of most companies is to generate profit, but it is still possible for a company to be involved in a capital transaction which will be excluded from gross income.

In the e-commerce environment it is virtually impossible to determine the intention of a taxpayer, especially in circumstances where the identification of the taxpayer is not known or capable of being verified with ease. Individuals need not provide proof of identification and false information can be supplied with ease. In the case of resident companies, the memorandum of association is difficult to find if the correct company name is not displayed on the website along with the registration number. Foreign companies have different rules that govern them which can further create difficulty. The identity of the directors or managers is not always known, which makes the determination of a company's intention a confusing exercise.

6.3.2.4 Year of assessment

Income must be received within a specific year of assessment to be taxable.[22]

The problem here is that transactions online take place immediately in real time. It may be difficult to determine the tax years of virtual companies, but in the case of resident companies, such details are usually contained at the Registrar of Companies' office at the Department of Trade and Industry in Pretoria. Where foreign companies receive income from a South African source, the year of assessment is, however, more difficult to determine.

6.3.3 The jurisdictional connectors: residence and source

Much has been said about the concepts of residence and source which are the jurisdictional connecting factors in most tax systems. It is thus necessary to examine these concepts further in order to understand why e-commerce often escapes the tax nets cast by revenue services worldwide.

6.3.3.1 South African residents

Natural persons/individuals

In terms of the Income Tax Act,[23] residents are taxed on their worldwide income (Stiglingh *et al.* 2010: 41).[24] To determine whether or not an individual is a resident of South Africa, a two-step test (Olivier & Honiball 2008: 16; Stiglingh *et al.* 2010: 50–51) is applied as set out in the definition

17 *Elandsheuwel Farming (Edms) Bpk v SBI.*
18 *CIR v Richmond Estates (Pty) Ltd*; Stiglingh *et al.* (2010: 29).
19 *John Bell & Co. (Pty) Ltd v SIR.*
20 *Natal Estates v CIR*; Stiglingh *et al.* (2010: 29).
21 Stiglingh *et al.* (2010: 31); *CIR v Richmond Estates (Pty) Ltd.*
22 In South Africa the year of assessment starts on 1 March and ends at the end of February of the next year. For companies the year of assessment is usually regarded as the financial year of the specific company as decided in the company's constitution (Stiglingh *et al.* 2010: 2).
23 Definition of "gross income" in Section 1 of the Income Tax Act.
24 For years of assessment prior to 1 January 2001, South Africa previously followed a source-based system.

of resident.[25] First it must be determined whether or not a person is ordinarily resident in South Africa. If the answer is in the affirmative the enquiry ends and the individual will be subject to income tax in South Africa.[26]

If, however, it cannot be determined where the individual is ordinarily resident, the second enquiry must be applied. This entails an enquiry into the physical presence of the person in South Africa (Olivier & Honiball 2008: 16).

Ordinarily resident in the Republic of South Africa

The term "resident", as contained in the definition of gross income, is defined for natural persons to mean "ordinarily resident in the Republic" (Meyerowitz 2007: par. 5.17). This phrase is not explained or defined in the Income Tax Act and therefore the interpretation of the courts must serve as a guideline when deciding whether or not a particular person is ordinarily resident in South Africa (Olivier & Honiball 2008: 16; Meyerowitz 2007: par. 5.17). This is regarded as a factual enquiry, determined with reference to the circumstances of the particular case (Stiglingh *et al*. 2010: 42).

In *CIR v Cohen* the court had to decide whether or not a person was ordinarily resident in South Africa, and stated that "his ordinary residence would be the country to which he would as a matter of course return from his wanderings; as contrasted with other lands it might be called his usual or principal residence and it would be described more aptly than other countries as his real home".[27]

If it cannot be determined whether or not a person's real home is located in South Africa, the physical presence test is applied to determine whether or not an individual was sufficiently present in the country so as to be regarded as a resident (Olivier & Honiball 2008: 16).

The physical presence test

If a person is physically present in South Africa for more than 91 days in aggregate during a year of assessment and more than 91 days in each of the five years prior to the year of assessment and more than 915 days in aggregate during the five years prior to the year of assessment, such a person will be regarded to be sufficiently physically present in South Africa and as a consequence be regarded a resident of South Africa. This means that the person will be liable for income tax on his or her worldwide income in the exact same manner as other individuals who are ordinarily resident in the country (Stiglingh *et al*. 2010: 51; Meyerowitz 2007: par. 5.18).[28]

Non-natural persons/companies

A person other than a natural person (which will be referred to as a company) will be a resident if it is incorporated, established or formed in South Africa, or if its place of effective management is situated in South Africa.[29] If a company is not incorporated, established or formed in South Africa, it will still be

25 The term "resident" is defined in Section 1 of the Income Tax Act as "any natural person who is ordinarily resident in the Republic; or not at any time during the relevant year of assessment ordinarily resident in the Republic, if he was physically present in the Republic for the required time; person (other than a natural person) which is incorporated, established or formed in the Republic which has its place of effective management in the Republic."

26 For an individual to be subject to income tax in South Africa there must also be compliance with the general definition of gross income.

27 This passage was quoted with approval by the then Appellate division in *CIR v Kuttel* at 248F-249I. The question also arises as to whether a person can be a resident of more than one state. It has been submitted that this is not possible because the use of the word "ordinarily" and the *Cohen* and *Kuttel* decisions prevent such an interpretation, and a person can only have one real home. In cases where a person is constantly travelling to such an extent that the location of his or her "real home" cannot be established, the onus will be on the taxpayer to prove that he is not ordinarily resident in South Africa (Meyerowitz 2007: par. 5.17).

28 It is possible for an individual to arrange his or her affairs in such a manner that the time spent in the country will be less than that required in terms of this test in order to avoid being taxed as a resident of South Africa. Electronic presence is not sufficient to render a person a resident of South Africa. The burden of proof will rest on the taxpayer to show that he is not liable for income tax (Section 82 of the Income Tax Act).

29 Section 1 of the Income Tax Act. There is no definition for the terms incorporated, established or formed. In general these terms do not pose any difficulty as it can easily be established at the Registrar of Companies in South Africa whether or not an entity is incorporated in South Africa in terms of Section 32 of the Companies Act 61 of 1973 (Stiglingh *et al*. 2010: 54).

regarded a resident company if its place of effective management is within the borders of South Africa (Stiglingh *et al.* 2010: 54).

The term "place of effective management" is also not defined in the Income Tax Act, but SARS has issued an interpretation note[30] in which they deem this to be the place from which the day-to-day management of the company takes place by the senior management of the company or by the directors (Stiglingh *et al.* 2010: 54). This interpretation note is not very helpful because it is possible for a company to be managed on a day-to-day basis in South Africa, but be controlled from abroad by shareholders who prescribe what its senior management and directors should be doing (*Cf.* Van der Merwe 2006: 125; Oguttu 2008: 90). Add e-commerce to the equation and the matter is complicated even further as the example of the French company explained above indicated.

Non-resident taxpayers

Non-residents are taxed on the amounts that they earn within the borders of the state if the income can be said to originate from a South African source or deemed a South African source.[31]

The Income Tax Act does not contain a definition of the phrase from a source within South Africa.[32] It was, however, held in *CIR v Lever Brothers & Unilever Ltd* that in order to determine the source, the originating cause for the income should be established and that the location of the originating cause will determine where or by whom the income will be taxed. To determine the originating cause of a receipt, regard must be had for the *quid pro quo* that was given by the taxpayer in return for the income.[33] If the activities that gave rise to the income are outside South Africa, an investigation must be made to see whether or not the deemed source provisions contained in Section 9 of the Income Tax Act apply. If one of the deemed source sections apply, then the income which is not from a South African source in terms of the test formulated by the court will be deemed to be earned in South Africa (Stiglingh *et al.* 2010: 55).

In *Millin v CIR* the court found that the source of royalty income earned in both the UK and South Africa was the place where the person had exerted her wits and labour. Where more than one source can be seen to give rise to income, the main, real or dominant source test will be applied.[34]

At first glance this seems simple, but in e-commerce, where many different functions of a person or company can be performed in many different source states, the dominant source test becomes very difficult to apply. An example of this can be seen in *ITC 1779*.[35] In this case an auditor used his Cape Town home to carry on part-time trade on the internet which involved certain currency exchange transactions. The facilities to trade online were provided by a global foreign exchange trader located in the US.

The transactions in which the taxpayer was involved took place via the internet and could not be linked to a physical location. He was situated in Cape Town (so as a resident of South Africa would be taxable in South Africa) and had his own dedicated internet line and computer software especially designed for this trading. The interesting aspect is that all the taxpayer actually did was to make certain decisions online while dealing with the global foreign exchange trader. He would offer to purchase an amount of pounds for the equivalent in euros and wait a while before selling it in another currency, hoping that the currency changes in the market would favour his decision. No money was actually transferred to him, but an account was maintained online where he could view his foreign

30 Income Tax Interpretation Note 6. Available at *http://www.sars.gov.za/home.asp?pid=54958*

31 Section 1, the definition of gross income, of the Income Tax Act (Stiglingh *et al.* 2010: Chapter 5).

32 Meyerowitz (2007: par. 7.4); Stiglingh *et al.* (2010: 47). *See CIR v Epstein* at 698 where the court stated that the difficulty of defining this phrase probably lay within the knowledge of the legislature. C.J. Watermeyer also stated in *CIR v Lever Brothers* at 454 that it was not possible to define "source" in such a manner that a standard test could be devised.

33 Meyerowitz (2007: par. 7.6). See *FNB of SA v CSARS* in which it was decided that a more holistic enquiry based on the substance of all the transactions must be done. This case is criticised by Davis (2002: 169 supra) as being a very vague test formulated by the court.

34 *CIR v Black* 1957 3 SA 536 (A); *cf.* Gutuza (2010: 333).

35 *ITC 1779.*

currency balance at any given time. Profits were allocated to this account and any losses suffered were set off against the same account.

The question before the court was whether the taxpayer was entitled to set off the losses incurred outside South Africa against his income earned in South Africa. The court applied the *Millin* case and found that such a set-off was possible because the taxpayer had exerted his wits in the decision-making process which was crucial in making a profit or loss from a South African source in Cape Town. The facts of this case illustrate the difficulties that can arise when international trade takes place in undisclosed online virtual locations.

6.3.3.2 Controlled foreign companies (CFCs)

In certain cases the income received by a non-resident company can be attributed to a South African resident if the CFC rules as contained in Section 9D of the Income Tax Act apply. Section 9D(2) states that a proportional percentage of the net income earned by a foreign non-resident company can be attributed to a resident if such a resident holds more than 50 per cent of the participation rights in the foreign company. This is a far reaching provision as the income is earned from a non-South African source, but is included in the South African resident's income merely due to the control that is exercised in South Africa (Olivier & Honiball 2008: 430).[36]

The CFC rules will not be applicable to a resident (or to the connected persons of such resident) if this resident holds less than 10 percent of the total voting rights or participation rights in the CFC or if such a resident holds the participation rights indirectly through another company or entity. There are also certain exclusions from the CFC provisions in the Act which apply to foreign business establishments, insurance policies, income already included in taxable income, foreign dividend income, interest royalties, rentals and similar income as well as capital gains (Section 9D9 of the Income Tax Act).

The amount which is included in the South African resident's income will be proportionate to the percentage of participation rights held by the resident. A simplified example is where a South African company holds 55 per cent of the voting rights in its subsidiary which is located in Mauritius. If the CFC rules are applied, then 55 per cent of the net income of the Mauritian company will be included in the income of the South African resident company (Buys & Cronjé 2004: 312). A detailed discussion of the CFC rules is not included here, but should be studied by anyone who wishes to specialise in this field.

The application of this section is one way in which the profits generated by e-commerce are included in the income of a South African resident. The business activities that take place online are taxed when the profits are received by the South African resident, irrespective of where it was earned. This will capture many transactions that previously were not taxed at all.

6.3.4 Transfer pricing

Transfer pricing is the practice of fixing prices between tax jurisdictions in such a manner that goods, services or resources are priced and paid for in low-tax jurisdictions usually for the benefit of the parties to a transaction who are mostly related to each other (Olivier & Honiball 2008: 484). This is achieved through overcharging in certain jurisdictions and undercharging in others. This results in the price of goods being transferred or payable in a lower tax jurisdiction and constitutes a form of tax avoidance. It is easier to achieve if related or connected entities are involved, for example subsidiary companies that are part of a group of companies that operate worldwide. The manipulation of the prices when goods or services between members of the group are exchanged can give rise to tax avoidance and/or evasion.

The Income Tax Act contains anti-avoidance measures that enable SARS to adjust the value of the consideration at which the goods or services were supplied if this value is not in proportion to the market value of the supply. Section 31(1) grants the power to SARS to adjust the price and bring it in line with the price that would have been paid on the open market under conditions that would have existed between unconnected persons in comparable circumstances.

These transactions are very difficult to trace and the principles in the Income Tax Act require that the pricing of such a transaction be corrected by comparing it to a similar transaction conducted at

36 The net income of a CFC is determined in accordance with the provisions of the Income Tax Act as if such CFC had been a resident taxpayer for the gross income definition. See also Sections 7(8), 10(1)(h), 25B, 31 and Schedule 8 of the Act.

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arm's length and adjusting the price in accordance with such a "normal" transaction (Olivier & Honiball 2008: 484). In cyberspace, where such transactions are very difficult to trace, information is not reliable and parties are often also not who they seem to be. These transactions and the anti-avoidance measures to combat such transactions are difficult to identify.

6.4 OBSTACLES CREATED BY THE USE OF E-COMMERCE

As has been seen from the discussion above, challenges that exist to traditional legislation include the "residentless" nature of trade on the internet, hidden identities of potential taxpayers, the nature of the goods traded, the immediate nature of transactions and multi-territoriality of entities, not to mention tax administration, compliance and tax evasion problems (Buys & Cronjé 2004: 314).

Another challenge which is often overlooked is the very nature of e-commerce itself. E-commerce is a term which includes all forms and stages of commercial activities which are done via computers. This includes everything from online banking, telecommunications, network and internet provision, online services such as rendering advice, providing digitised goods and services, as well as the production of intellectual property and consequent use thereof on the internet (Davis 2002: 161–162).

The traditional sale of goods and services online is included in this all-embracing term. The less traditional activities, which are so closely connected to the very system on which they occur, often give rise to revenue which is not included in either the tax calculations of the revenue service nor of the taxpayers. An example of this is the rise in value of intellectual property, such as where a free download of a digital product is made available, and the brand of the company that grants the free product is thereby promoted and as a consequence its value increases. This can lead to increased value of the goodwill of the business and more transactions which give rise to more income. It is extremely difficult to measure or quantify such an increase in value, not to mention levying income tax or capital gains tax on it.

The digital nature of products available on the internet, such as music recordings, videos and software that are simply downloaded directly to the consumer's cellphone, iPod or computer also creates a complex web of international trade, some of which occurs in cyberspace and is not attributable to any given location (Fitzgerald *et al.* 2007: 575).

In terms of the South African system specifically relating to the definition of gross income, how does one determine the monetary value of the goods or services provided? Can they be turned into money as required by the decisions in the *Lategan* and *Delfos* cases? And how will the value be apportioned between the countries in which it is earned in terms of the source principles? How does one identify, value or trace such transactions? Was any value received by the taxpayer or has it accrued to him? Is the value which has been received or accrued of an income or capital nature? These are typical questions that are raised to decide whether or not an amount is taxable in South Africa before any calculations can be made. The most important global connecting factors as mentioned above are residence and source. Many international bodies, such as the Organisation for Economic Cooperation and Development (OECD), the UN and various governments have attempted to resolve the e-commerce dilemma in recent years while also trying to avoid the incidence of international double taxation.

6.5 INTERNATIONAL INCOME TAX LAW AND E-COMMERCE

6.5.1 Historical background

Initially, during the late 1990s, the question whether or not internet transactions should be taxed at all was very controversial. In 1998 the US government was of the view that they should not be subject to tax at all and even passed legislation to this effect. This view was soon changed, and in 2000 the US government supported the leadership of the OECD in the coordination of international tax initiatives. At the same time the OECD, the Australian Tax Office (ATO) and the UK government developed reports and discussion papers which contained the principles upon which e-commerce should be taxed. These principles were neutrality, efficiency, certainty and simplicity, effectiveness, fairness and flexibility, and are still widely accepted as the basis upon which e-commerce should be taxed (Fitzgerald *et al.* 2007: 576–579). These principles were contained in the OECD's Ottawa Taxation Framework Conditions.[37]

37 Available at *http://www.oecd.org/dataoecd/46/3/1923256.pdf*.

South Africa incorporated these principles in the Green Paper on Electronic Commerce for South Africa in November 2000,[38] but no further legislative development has taken place since. South Africa concluded several Double Tax Agreements (DTAs)[39] based on the OECD Model Tax Convention,[40] but none of the treaties concerned specify how e-commerce transactions should be treated.[41]

6.5.2 Methods to avoid international double taxation

International double taxation is a risk faced by taxpayers who engage in e-commerce. The Income Tax Act provides for a few methods for eliminating double taxation such as the deduction, credit, exemption and double tax treaty methods (Olivier & Honiball 2008: 4).

South African residents are taxed on their worldwide income irrespective of where it is earned, whereas non-residents are taxed on income earned from a South African source as explained above.

South Africa is party to many DTAs. These are concluded to alleviate the possibility of a double taxation regime being levied on the residents of the two contracting states and to determine the source rules that apply between such parties (Olivier & Honiball 2008: 1). They also serve as a mechanism to ensure that tax evasion is minimised (Buys & Cronjé 2004: 301).

Section 108 of the Income Tax Act states that a DTA is part of South African domestic law, but does not clarify which of the two instruments (the Income Tax Act or the DTA) will prevail if conflicting provisions exist. In South Africa, a DTA has the same status as domestic law, and where uncertainty exists regarding the interpretation of a provision of a DTA, it is submitted that the South African Domestic Tax Law will prevail. E-commerce transactions can lead to two or sometimes more DTAs being applicable, and in the case of conflicting provisions, there should be regard for the OECD's position.[42]

In situations where a taxpayer is involved in cross-border transactions in a territory with which the South African government has not concluded a tax treaty, relief from double taxation will have to be sought in terms of Section 6 (*quat*) of the Income Tax Act. As most countries have been active internationally in the conclusion of DTAs, this chapter will focus on the relief provided for in the OECD Model Tax Convention on Income and Capital (OECD MTC)[43] upon which most of the DTAs are based.

6.6 THE OECD MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (OECD MTC)

South Africa is not a member state of the OECD nor has it signed and ratified the OECD MTC, but in practice it mostly follows the recommendations of the OECD. Most of the DTAs that South Africa has entered into are based on the OECD MTC.[44] The South African Constitution further states that cognisance should be taken of international law when interpreting South African law, thus instruments that are helpful such as the OECD MTC should be taken into account (Section 233 of the Constitution of the Republic of South Africa).

38 Coordinated and compiled by the Department of Communications of the Republic of South Africa in November 2000. Available at *http://www.info.gov.za/view/DownloadFileAction?id=68917.*

39 A DTA is a bilateral agreement between two states in which they assent to rules that will govern the jurisdiction to tax transactions or activities that occur within both states (Olivier & Honiball 2008:1).

40 Available at *http://www.sars.gov.za/home.asp?pid=160*

41 *Ibid.*

42 In *SIR v Downing*, the court implicitly gave its approval for the interpretation of the OECD MTC as contained in the Commentaries of the OECD by interpreting the facts of the matter in accordance with such commentaries. Since this decision it was generally accepted that these commentaries may be used as a persuasive source in arguments.

43 OECD Committee on Fiscal Affairs 2008.

44 In *SIR v Downing*, the court impliedly gave its approval for the interpretation of the OECD MTC as contained in the Commentaries of the OECD by interpreting the facts of the matter in accordance with such commentaries. Since this decision it was generally accepted that these commentaries may be used as a persuasive source in arguments.

6.6.1 Residence and place of effective management

Article 4 of the OECD MTC contains the provisions that determine residency of individuals and companies. A four-step test is applied to determine residence of a person. If he has permanent homes in more than one state, then it is the state in which personal and economic relations are closer which will prevail (residence also refers to the person's centre of vital interests). If these cannot be determined or there is no permanent home, an enquiry into the habitual abode of the person must be made. If there is no habitual abode or a dual presence, the state of which the person is a national will be his residence. In cases where this enquiry is still not resolved and a person is a national of two states or both, then the states shall by mutual agreement determine the residence of an individual (Article 4 par. 2 of the OECD MTC).

In terms of Article 4(3) the residence of a company which is resident in both contracting states will be where the company has its place of effective management. Place of effective management is referred to in the commentaries to the OECD MTC as the place where the key decisions regarding management and commercial activities are made in substance by the most senior managers of a business.[45] This is certainly not an easy place to find. With the emergence of telephone conferencing, for meetings several senior management officials can be engaged in decision making in several states at the same time. The location of decision making cannot truly be determined in such a case. This is not a static concept either, as such managers can move physically between states or can decide to hold meetings or make decisions online in real time by using internet chat facilities, which will in terms of the OECD MTC render the place of effective management to be cyberspace (a place which is not determinable).

The rules provided for in Articles 4(2) and 4(3) of the OECD MTC once again illustrate the difficulties in determining residence of individuals and companies that engage in e-commerce. The concept "place of effective management" is not always effective. More than two states may be involved in the transactions that occur. This article does not make provision for rules that will apply when residency in more than two states becomes a possibility, but only determines the rules for bilateral relationships.

6.6.2 Business profits and the concept of "permanent establishment"

In a situation where the residence of a person cannot be determined, the concept of a permanent establishment (PE) provides guidance in creating a connecting factor to a particular state in order to found jurisdiction to levy income tax.

In terms of Article 7 of the OECD MTC, the business profits of a particular enterprise are only taxed in the resident state of the enterprise and not in the country of source, unless it has a permanent establishment in the source state. If the business has a permanent establishment in the source state, the profits that are attributable to it will be taxable in the source state. It is therefore important to know exactly what constitutes a permanent establishment.

A permanent establishment is defined in Article 5(1) of the OECD MTC as "a fixed place of business through which the business of an enterprise is wholly or partially carried on." Article 5 also lists specific inclusions in the concept, such as the place where management takes place, a branch, an office, a workshop, a mine or gas or oil well, a quarry or place of extraction of natural resources.

Under Article 5(3) a building site, construction site and installation project shall only be regarded to be a permanent establishment if it has lasted for more than 12 months. A dependant agent can also create a permanent establishment through his or her presence and activities on behalf of the business enterprise (Par. 5 of Article 5 of OECD MTC 2008). Such an agent must have the mandate to regularly and habitually enter into contracts on behalf of the business or enterprise which it represents (OECD 2008).[46]

Similarly certain activities or uses are excluded from the scope of this article, among others the use of facilities and maintenance of stock and goods which are intended solely for display, delivery or storage purposes, maintenance of a fixed place of

45 OECD Commentaries on Article 4(3) of the OECD Model Tax Convention 2008, par. 24, p 77.

46 OECD Model Tax Convention Commentaries 2008, par. 31–35, pp 92–94.

business for preparatory activities, solely to purchase goods or merchandise or collect information.[47]

It seems that in general if the purpose of the fixed place of business is secondary in character and is not closely connected to the main business of the enterprise, even a fixed place of business in another state will not be deemed a permanent establishment for tax purposes.

It also seems that a degree of physical presence is required in terms of the concept of fixed place of business. The question arises as to whether or not e-commerce and presence on a website can satisfy the requirement of this definition of permanent establishment and as a consequence give rise to tax liability in a source state in which the business is not resident. Or would the use of the internet qualify as an exclusion from this requirement because it is used solely for display purposes? It is clear that an investigation into the facts of a particular situation are necessary to answer these two questions. There are, however, general principles that can be applied in this situation.

6.6.3 Can e-commerce activities constitute a permanent establishment?

In e-commerce the use of websites, webpages and servers in different states where the management activities of a business are not necessarily exercised (and the business is therefore a non-resident) is not uncommon (Davis 2002: 162; Buys & Cronjé 2004: 303).

The commentaries to Article 5 of the OECD MTC contain useful guidelines to answer the question as to whether or not a website, webpage or server can be regarded as a permanent establishment and as a consequence create a connecting factor with a state in which it is a non-resident.

The principle requires that computer equipment such as the actual physical machine (which can be traced to a physical location and form a permanent establishment, provided that it complies with the requirements set out above) must be treated differently from the data and software which are stored on the machine. A website consists of data and software that in essence exist in cyberspace and cannot be traced to a specific tangible asset. This means that it cannot be attached to a specific location to constitute a fixed place of business as required. A server on which the information is stored and which provides access to such a website is usually a piece of equipment which can be traced to a physical place, and the place where the server is located could qualify as a permanent establishment.[48] This makes sense if one considers the exclusions to the concept of permanent establishment, such as the storage of information or use and maintenance for display and delivery only as contained in par. 4 of Article 5.

Often in e-commerce an enterprise does not own its own server, but pays a fee to an internet service provider (ISP), which is a separate enterprise which hosts the server and provides access to the website or webpage that the business makes use of.[49]

The mere hosting of a server does not in terms of the OECD commentaries amount to the establishment of a PE. If, however, a business controls, owns, leases or operates a server, the place where it is located will in all probability constitute a PE, provided that all the other requirements are met.[50]

A problem which still arises is the fact that even such equipment may be moved, in which case the fixed nature of the server may be affected or the tax jurisdictional link lost. The OECD commentary on e-commerce as it relates to a PE states clearly that the test is not whether the machines are capable of being moved, but whether they are in fact moved. This is difficult for revenue authorities to apply in practical circumstances, because it would mean that they would have to keep track of non-residents' computer equipment in their territory.[51]

In addition to the business having a server in a particular state, it is further required by the OECD that the business must wholly or partially carry on its core business at the place where the server is

47 *Cf.* par. 4 of Article 5 of the OECD Model Tax Convention; on the concept of permanent establishment. See Oguttu & Tladi (2009).

48 OECD Model Tax Convention Commentaries 2008, par. 42.2, p. 97.

49 OECD Model Tax Convention Commentaries 2008, par. 42.3, pp. 97–98.

50 OECD Model Tax Convention Commentaries 2008.

51 OECD Model Tax Convention Commentaries 2008, par. 42.4, p. 98.

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located. It is clear that when an ISP provides access to a website, only the ISP will have a sufficient link with the state in which the server is located, because it carries on the business of providing internet access.[52] The provision of a communication link, advertisements, or gathering or passing on information will, for example, be activities that will be regarded as preparatory or secondary in nature.[53] The presence of staff is not a requirement for the establishment of a PE, but each case must be judged on its own merits and the facts.[54]

The question arises as to whether or not an ISP will constitute a PE for purposes of the business which makes use of its services. The OECD commentaries raise a very valid point, namely that the ISP will not usually be an agent with the authority to regularly enter into contracts in the name of all the businesses that make use of its internet services. This means that the requirements of the dependent agent as contained in Article 5 of the OECD MTC are not met. A further requirement of Article 3 of the OECD MTC that is not met by a website (ISP) through which a business may operate is that such a business must be a person as defined in order for Article 5 to apply. A website is not included in the definition of a person in the OECD MTC, and therefore a website in another country cannot be said to form a PE.

If the business has its own server which it controls in a jurisdiction, it will not be a resident there, but it will have a PE in the second state. The profits that are attributable to the PE of the business will be taxed in the state where the PE is situated.[55] The question that now arises is how this attribution will be done specifically for e-commerce where the exact locations of transactions are difficult to determine.

6.6.4 Attribution of the business profits

In terms of Article 7 of the OECD MTC only the amounts that are attributable to the PE will be taxed in the country where the PE is situated. To determine these amounts, the PE should be treated as if it were a separate business from the enterprise that it represents, but should still be treated as if it were operating in similar circumstances as the main enterprise and as if it were dealing independently of the main enterprise. Certain deductions may be made by the PE from its profits, such as operating costs and salaries. The profits can then be determined as deemed fit by the source state where the PE is located. The mere purchase of goods by the PE on behalf of the main business that it represents will not be sufficient to cause the attribution of profits to the PE.

The Report of the Technical Advisory Group (TAG) on Monitoring the Application of Existing Treaty Norms of the OECD Committee on Fiscal Affairs indicated in 2005 that there was not sufficient evidence of a big enough reduction in direct tax revenue to justify a change in the treaty rules so that e-commerce could be caught in the income tax net of the various source states. Although it was recognised that e-commerce could lead to large quantities of income generated in states without attaining the levels of physical connection required for a PE to exist, changes were not made to the current OECD MTC. Some suggestions were discussed by the TAG such as the addition of new connecting factors to include electronic transactions in the definition of PE. Several suggestions were made, among others the development of a "virtual fixed place of business" to be applied in cases where a business makes use of a website, which means that the place of business will be the website. This would then do away with the tangible asset and physical presence currently required by the OECD MTC. A further suggestion was to include a "virtual agency" in the definition of a PE. This aims at including online agents that conclude electronic contracts on behalf of a business on a regular basis. The third suggestion was to create a threshold of time periods or a monetary limit according to which an "on-site business presence" in another state may be operated tax free. If the threshold is exceeded the result will be tax liability in that other source state (Fitzgerald *et al.* 2007: 593–5).

The reasoning of the TAG of the OECD that there is not sufficient revenue loss to warrant these changes is not convincing. The real problem is practical implementation coupled with the lack of information to track all communications online and further classify which transactions will be subject to which specific type of tax.

52 *Idem* at par. 42.5–42.9.
53 *Idem* at 42.7.
54 *Idem* at 42.7.
55 Article 7 of OECD Model Tax Convention 2008, pp. 26–27.

6.7 CLASSIFICATION OF TRANSACTIONS

In terms of the South African Income Tax Act, the manner in which any type of receipt is classified has an impact on the manner in which it is taxed. Certain types of income will be subject to normal income tax, which will be calculated in terms of the principles set out above, starting with the question whether or not the definition of gross income can be applied. In other cases a specific type of income or person will be subject to a withholding tax which has a different structure to normal income tax. If amounts are received that are subject to a withholding tax, the taxpayer will be taxed on the gross amount that is received. Normal income tax is calculated on a net amount after the deduction of certain losses and expenses.

In terms of Section 35 of the South African Income Tax Act, a withholding tax is levied on income that can be classified as royalties. The OECD defines royalties in Article 12 (2), and the crux of the definition relates to the use of copyright, artistic works or trade marks and other listed types of intellectual property rights.

The question arises as to whether payment for downloading software from a website should be classified as royalties and thus subject to the withholding tax, or whether it should be classified as normal income. This question so far remains unanswered.

6.8 CONCLUSION

It is clear from the discussion above that a multitude of problems exist in the application of the substantive income tax rules to e-commerce. The same problems and additional unique challenges also exist in the field of value-added tax (VAT) which are discussed in Chapter 7.

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