

**A CRITICAL ANALYSIS OF THE PRINCIPLE OF
PERMANENT ESTABLISHMENT AND RELATED TAX
RULES IN ESTABLISHING TAXING RIGHTS WITH
REFERENCE TO E-COMMERCE**

by

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ABSTRACT

A CRITICAL ANALYSIS OF THE PRINCIPLE OF PERMANENT ESTABLISHMENT AND RELATED TAX RULES IN ESTABLISHING TAXING RIGHTS WITH REFERENCE TO E-COMMERCE

by

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DEGREE: Magister Legum in Taxation

E-commerce challenges traditional taxation rules and tax authorities find it difficult to effectively tax business profits derived from cross-border commercial transactions utilising the Internet.

This study analyses the fundamental principles of the concept of permanent establishment and related international tax rules and assess the traditional requirements against the unconventional characteristics of e-commerce. Whilst the features of e-commerce ignore territorial borders and geographic locations, that is, the status of a virtual presence, the concept of permanent establishment (still) calls for a fixed location in a country, which relates to a physical presence.

Gaps and mismatches in tax rules have allowed multi-national enterprises to adopt strategies to shift profits to low or no-tax jurisdictions and prompted the OECD to launch a Base Erosion and Profit Shifting (BEPS) initiative to counter tax avoidance. Today, more than 100 countries are collaborating to implement the reform measures which include actions to address the tax challenges of the digital economy and to prevent the artificial avoidance of permanent establishment status.

The research concludes that the OECD reform measures do not adequately address the issues relating to the concept of a permanent establishment in situations where enterprises conduct cross-border e-commerce based on a digital business model. Furthermore, the study submits that due to the traditional permanent establishment (*nexus*) approach, cases of e-commerce may challenge a country's taxing rights by virtue of there being no physical presence to constitute a permanent establishment.

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List of Acronyms

ATAF	African Tax Administration Forum
BEPS	Base Erosion and Profit Shifting
CFC	Controlled Foreign Company
CIT	Corporate Income Tax
DTA	Double Tax agreement
EU	European Union
EC	European Commission
IMF	International Monetary Fund
MNE	Multi-national Enterprise
MTC	Model Tax Convention
PE	Permanent Establishment
PPT	Principle Purpose Test
POEM	Place of Effective Management
OECD	Organization for European Economic Cooperation
SA	South Africa
SARS	South African Revenue Services
UN	United Nations
WB	World Bank
DTA	Double Tax Agreement
POEM	Place of effective management
SCA	Supreme Court of Appeal

The line it is drawn

The curse it is cast

The slow one now

Will later be fast

As the present now

Will later be past

The order is

Rapidly fadin'

And the first one now

Will later be last

For the times they are a-changin'.

From “The Times They Are a-Changin’” by Bob Dylan, 1964,

American songwriter, singer, artist and writer who has been awarded the Nobel prize
in Literature on 13 October 2016.

Chapter 1

Introduction

1.1 Problem Statement

The Katz Commission, in dealing with International compatibility as one of the elements of a balanced tax system and referring to treaty rules, reported that “Usually, a permanent establishment is established through a presence in the source country of a fixed base which is used regularly.”¹ The Commission recommended that the definition of a permanent establishment be changed to replace the requirement of a fixed place of business with a “facility suitably equipped”.² The Commission, however, concluded by recommending that the principle and definition followed in international tax treaty law should be introduced. This study will argue that not much has changed in almost 20 years and that the concept of ‘permanent establishment’ is outdated and no longer a comprehensive test to determine taxing rights with regards to electronic commerce (“e-commerce”).

The Explanatory Statement to the OECD/G20 BEPS (Base Erosion and Profit Shifting) Project acknowledged that “International tax issues have never been as high on the political agenda as they are today.”³

Although not quantified scientifically, it is estimated that Corporate Income Tax (“CIT”) losses suffered by tax authorities worldwide could be in the order of USD 100 - 240 billion or between four to ten per cent of global CIT revenues annually.⁴

Countries, including South Africa, do not effectively tax income from cross-border e-commerce transactions and dated tax principles have eroded the ability of many

¹ Katz Commission, *5th Report- Basing the South African Income Tax System on the Source or Residence Principle Options and Recommendations*, Chapter 3, Para 3.1.5.2, Subpara (ii)(a), March 1997.

² Katz Commission *ibid*, Chapter 5, Para 5.4.1, Subpara 5.4.1.1.

³ OECD (2015), Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project, OECD. www.oecd.org/tax/beps-explanatory-statement-2015.pdf.

⁴ *ibid*, Introduction, at 4, Para 2.

countries to tax these commercial activities. It is seen as an encroachment on the sovereignty of states to tax this dynamic and growing marketplace.

Internet, business technology and the integration of markets across the globe have been the main enablers of e-commerce which has resulted in a growing digital economy.

The Internet is a global network of networks connecting computers and electronic devices across the world, thereby allowing access to online shopping, newspapers, books, computer software, music, films, gaming and published information from the comfort of your armchair. It allows everyone who has access to a computer or mobile device to have a reliable and flexible medium to communicate and conduct business. Internet is defined⁵ as "...an interconnected system of networks that connects computers around the world through a software protocol known as TCP/IP⁶". In an earlier edition of *Cyberlaw* it was defined as a "...worldwide network of networks that use TCP/IP communications protocol and share a common address space."⁷ In *Telkom SA Limited v Napa Maepe and two others*, Judge Du Plessis defined a network as "a number of computers linked together to share information."⁸

Tax regimes in general recognise territorial taxation by the source country and personal taxation by the resident country.⁹ E-commerce, however, challenges these concepts by making it difficult to establish a norm or justify and implement a practical tax dispensation.

South African tax legislation and principles determined by the judiciary, for example, the 'place of management' and the requirement of a physical presence in order to conduct business as required by the concept of 'permanent establishment', were

5 *Cyberlaw @SA, III, The law of the internet in South Africa*, Third edition, S Papadopoulos and S Snail (Editors), Van Schaik Publishers, 2012, at 2.

6 Section 1 of the Electronic Communications and Transactions Act 25 of 2002. TCP means Transmission Control Protocol and IP means Internet Protocol.

7 *Cyberlaw @SA, The Law of the Internet in South Africa*, R Buys (ed.), First Edition, Chapter 14.

8 *Telkom SA Limited v Napa Maepe*, South Africa Telecommunications Regulatory authority and The Internet Service Providers Association, unreported case, case number 258940/97 TPD.

9 Reuven S. Avi-Yonah et al, *US International Taxation: Cases and Materials* 3rd Edition 2010.

designed or laid down by the courts at a time when today's technology was seen as science fiction.

'Permanent establishment' is defined in the Income Tax Act, section 1 to have the same meaning as the definition contained in Article 5 of the OECD MTC.

It is clear that the principle, dealt with in more detail in Chapters 3 and 7 of this report, is a tax treaty concept incorporated into South African domestic law.

Although some large multi-national corporations such as Apple (with iStore) and Amazon, since legislation in 2014, now charge VAT on sales in South Africa, it is probable that the majority of smaller online businesses still escape VAT liability, including liability for direct income tax on business profits generated through e-commerce when transacting with South African resident consumers.¹⁰

Today, many questions remain unanswered, for example:

- In which territory is the income from e-commerce transactions generated?
- Where are these transactions taking place in cyberspace?
- Under which jurisdiction should the income accruing from these transactions be taxed?

In February 2013, the OECD acknowledged the risk to taxing rights of countries and stated "...the international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment."¹¹

¹⁰ A definition of 'importation' has been inserted by section 19 (1) (g) of Bill 14 of 2014, in the Value-Added Tax Act 89 of 1991 and the definition of 'electronic services' inserted by s. 165(1)(d) of Act 31 of 2013 with Regulations prescribing "Electronic Services" for the purpose of the definition of "Electronic Services" published in the Government Notice No 37489, dated 28 March 2014.

¹¹ OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing.
<http://dx.doi.org/10.1787/9786264192744-en>, at 5.

With the progressive development of e-commerce and the extent of growth predictions in years to come, it was stated as early as the year 2000, that,

“...[t]ax authorities will have to adapt their application of existing tax principles, practices and procedures for an e-commerce environment. Alternatively, new methods of levying and collecting taxes will have to be devised. Taxpayers, on the other hand, will have to adapt their tax planning strategies and consider the impact of a changing business environment on their global tax charge.”¹²

Reflecting on the response from tax administrators as to what has occurred in the international tax arena, it appears that multi-national taxpayers have indeed adjusted their tax planning strategies and progressively kept abreast of changes, to their own benefit. The question can be asked and is dealt with in more detail in this study as to whether tax authorities have demonstrated the same readiness to change.

At the time of finalising this research report it was questionable as to whether the South African Tax authority has legitimate taxing rights with regards to profits derived by foreign legal persons (non-residents) in terms of cross-border e-commerce business activities conducted in South Africa.

1.2 Background

It was JCR Licklider of the Massachusetts Institute of Technology who in 1962 recorded the concept of a globally interconnected set of computers.¹³ Two years later Herbert Marshall McLuhan, a Canadian Professor of English and a philosopher of communication theory, who predicted the creation of the internet 30 years before its existence, stated that the world will become an interconnected global village driven by the media through electronic technology.¹⁴

¹² *Taxation of E-commerce: Income Tax* in Buys R (ed) *Cyberlaw@SA*, Van Schaik Publishers Pretoria 2000 by B Du Plessis and M Viljoen, at 231.

¹³ A series of memos by Licklider, J.C.R., and Clark, W, *On-Line Man-Computer Communication*, Aug. 1962.

¹⁴ *Understanding Media*, published in 1964, http://www.livinginternet.com/ii_mcluhan.htm.

Bill Gates, the entrepreneur, philanthropist and co-founder of Microsoft, warned in December 2000 that “The Internet will have (a) profound effect on the way we work, live and learn” and added that “The Internet is becoming the town square for the global village of tomorrow”.¹⁵

An article in Rapport quoted Ms Sunita Manik, Group Executive of SARS Large Business Centre, in which she warned that international tax systems have become obsolete causing the tax sovereignty of countries to deteriorate.¹⁶ The effect is that multi-nationals may shift their profits to lower tax jurisdictions while at the same time continue to conduct business in higher tax jurisdictions. As e-commerce is hosted on web servers, it is easy to move it to low tax jurisdictions. Professor Deborah Tickle, Tax Partner at KPMG, referred to the situation pertinently as “Globalisation and the digital age have caused the world to ‘shrink’.”¹⁷

In addressing the worldwide tax challenges that countries face with regards to cross-border e-commerce, Arthur J Cockfield, stated that

“Ten years after these challenges were first identified, a survey of national government reactions shows that many countries have not passed any significant tax legislation or administrative guidance with respect to the taxation of global e-commerce.”¹⁸

It comes as no surprise to note the apprehensive initiatives from the OECD and its member states which took the lead with the Base Erosion and Profit Shifting report (BEPS) containing fifteen actions of which one is to address the artificial avoidance of ‘permanent establishment’ status caused by globalisation and the growing digital economy.¹⁹

¹⁵ *In Shaping the Internet Age*, Posted December 1, 2000 by the Internet Policy Institute of Microsoft by Bill Gates Chairman and Chief Software Architect, Microsoft Corp.

¹⁶ Sake Rapport 14 July 2015.

¹⁷ *Accountancy SA, Analysis: Is there a future for International Tax Planning*, by Prof Deborah Tickle, Tax Partner at KPMG, 1 May 2015.

¹⁸ *The Rise of the OECD as Informal; World Tax Organization; Through National Responses to E-commerce Tax Challenges*, 23 January 2014, published on <http://taxblog.com>.

¹⁹ OECD (2013), *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing.

After more than a decade since the challenges of e-commerce emerged many countries have yet to pass legislation or guidelines relating to the taxation of e-commerce. With the developments in information technology over the years, digital transformation has given rise to an e-commerce economy with unprecedented consequences and infringement on tax collection.

With the benefit of hindsight, the rapid progress of information technology and globalisation in recent decades has not brought more union and more equality amongst countries around the globe from a tax perspective. This has rather given rise to new challenges for governments to exercise control, claim and collect their 'rightful' taxes. To add to that, the world financial catastrophe of 2008 and the global economic woes thereafter raised astute awareness for growth across the globe. This has resulted in a renewed fiscal focus by governments who, it is believed, have been losing substantial tax revenue due to the significant drop in economic growth following the financial crises.

1.3 The challenges today

Conducting business by using computer networks has brought a digital economy with strong indicators of economic growth, job creation and world trade that ignores the boundaries of countries and has transformed the world into a digital market place.

The Internet and computer technology have created what is known today as 'cyberspace' in which geography is irrelevant. This phenomenon ignores geographic coordinates and, hence, a physical presence, a point of place or location bears very little relevance.

In dealing with the scope of jurisdiction of the Internet, Dan L. Burk stated that "...the unique nature of the Internet may necessarily trigger constitutional limitations designed to limit governmental regulation originating outside the state's physical

borders.”²⁰ With this dimension of no physical space, cyberspace calls for creative thinking by states to conceptualise this digital transformation into law and especially tax law. The long-standing principle of sovereignty, that is to say, that a state has jurisdiction over its territory and subjects, does not recognise the reality brought about by the digital transformation of business.

The concept of a ‘virtual presence’ has raised the question of how one should conceptualise, define and apply that in a tax system where tax principles still prescribe a physical presence test, for example, the Permanent Establishment test contained in Double Tax Treaties between South Africa and other states.

In Cyberlaw it is stated that “The Internet has bridged the geographic remote, and allows access to the entire digital world without moving away from one’s PC.”²¹ More and more we learn of virtual presence, a concept that is replacing physical presence as claimed by tax principles like ‘permanent establishment’. The effect thereof is the seamless flow of money, services, information and goods across jurisdictions and states. From a tax perspective, this brings into question where these transactions in cyberspace are taking place, which jurisdiction or state will or may claim taxing rights and how will the collection of tax, be enforced?

Furthermore, the challenge that tax authorities are faced with is that besides e-commerce ignoring geographic locations and physical presence, it brings buyers and sellers into the same virtual space or market place.

The concept of double tax treaties, as it is known today, was implemented almost a century ago to avoid exactly that, that is to say, double taxation.²² Governments, however, are now confronted with the reality that globalisation and digital transformation (may) lead to double non-taxation.

20 *Virginia Journal of Law and Technology*, published by the University of Virginia in Spring 1997, 1 Va. J.L. & Tech.3, paragraph 6, written by Dan L. Burk, Chancellor’s Professor of Law at the University of California, Irvine accessed through <http://vjolt.student.virginia.edu>.

21 *Cyberlaw @ SA II* by Reinhardt Buys and Francis Cronje, Second Impression of 2008, Van Schaik Publishers, at 101.

22 League of Nations, Fiscal Committee Report to the Council on the Fifth Session of the Committee, held at Geneva from June 12th to 17th, 1935.

Barlow, wrote a scathing attack on the US Government's Telecom 'Reform' Act of 1996 that "Cyberspace consists of transactions, relationships, and thought itself, arrayed like a standing wave in the web of our communications.²³ Ours is a world that is both everywhere and nowhere, but it is not where bodies live."

It is questionable whether adequate changes to domestic legislation to address the pressing concerns will materialise in the near future. This study formulates an argument in Chapter Seven that to the extent that countries merely adopt the OECD reform measures, they will probably fail to achieve the desired results which can only be addressed with a consistent international solution without complexities.

The current predicament for tax authorities is that by applying double tax treaties a carefully structured use of business entities with or without permanent establishments could well lead to double non-taxation or at least a substantial loss of tax revenue to many states.

1.4 Motivation and rationale of the study

International tax rules have not changed significantly over the last decade and by default this has created opportunities that cause, what is today termed as Base Erosion and Profit Shifting ("**BEPS**"), a concept which enjoys the attention of many countries and features high on the political agenda.

The G20 Leaders endorsed the BEPS Action Plan at a meeting in September 2013. The meeting declared that fundamental changes to international tax rules and principles were needed to counter legal arbitrage opportunities by multi-national enterprises. It was noted with concern that an increase in cross-border activities in recent years, the pace of integration of economies and the erosion of clear and binding tax rules have given rise to critical tax challenges resulting in BEPS. This prompted some 90 countries to embrace in negotiations designing the measures to ensure that profits are taxed where economic activity takes place and value is created. The G20, OECD, European Commission, IMF, World Bank, United Nations,

²³ Davos, Switzerland, February 8, 1996, accessed through <https://www.eff.org/cyberspace-independence>.

regional tax organisations and participating countries have contributed to the foundation of a modern international tax framework, published as a final set of reports in October 2015.²⁴

Double Taxation Agreements and Protocols between South Africa and countries worldwide, of which there are 87 currently in force, contain provisions, definitions and or principles that are similar in form and effect, for example, ‘Permanent establishment’ as contained in the OECD and other Model Tax Conventions and reference thereto in Article 5 and Article 7(1) of the Double Tax Agreements.²⁵

Furthermore, a number of definitions in the Income Tax Act²⁶ and principles referred to in more detail in Chapter Three below are to be tested for relevancy of application to cross-border e-commerce and with reference to the requirement of an element of physical presence, as contained in Double Tax Agreements, for example:

- The generally accepted definition of ‘source’ as laid down by Watermeyer CJ in *CIR v Lever Bros & Unilever Ltd* and other case law in this regard;²⁷
- ‘Residence’ of a juristic person with reference to place of incorporation, place of effective management and the requirement of activities, operations and functions taking place at a physical location; and
- ‘Place of effective management’ being the alternative statutory test to determine whether a legal person is a resident for purposes of tax in South Africa.²⁸

The objective of this study is to conduct research into what has given rise to the current challenges, taking into account the history of principles underlying the taxation of income accrued by virtue of cross-border transactions, more especially electronic commercial activities.

24 OECD (2015), *Explanatory Statement, OECD/G20 Base Erosion and Profit Shifting Project*, OECD. www.oecd.org/tax/beps-explanatory-statement-2015.pdf.

25 Source: *List of Treaties and Protocols* available on www.sars.gov.za with updates to 7 August 2015.

26 Act 58 of 1962.

27 1946 AD 441, 14 SATC 1.

28 The Revenue Laws Amendment Act 59 of 2000 and the Income Tax Act 58 of 1962 as amended.

This study will highlight the tax reform and transformation that is required to develop guiding principles and tax rules to deal with e-commerce challenges from a tax perspective. It will critically analyse the reform process and development of the newly published standards that are required in Model Tax Conventions, Double Tax agreements, administrative guidance and legislative measures.

1.5 Scope and limitations of the study

The research consists of a review of the traditional tax rules and international policies, the development of e-commerce and its effect on the taxing rights of countries, including South Africa, as well as the OECDs proposed reform measures to develop guiding principles in order to confront international challenges caused by cross-border trade.

The focus is principally on permanent establishment and why a physical presence or location with geographic coordinates is no longer required for e-commerce.

This research excludes Value Added Tax and similar consumption taxes and focuses on the taxation of 'business profits', a term used in the OECD Model Tax Convention and also in tax treaties, accrued by virtue of electronic cross-border transactions for purposes of Income Tax. It is further restricted, primarily, to persons other than natural persons, that is to say, juristic or legal persons and includes what is commonly referred to as multi-national enterprises.

This study concludes with a focus on the OECD Reform initiatives contained in Actions 1 and 7 of the BEPS Project.

1.6 Approach and methodologies

The approach adopted for this critical analysis consists of research into the reform process, proposed action plans, commentary and papers by various international organisations and tax analysts. Furthermore, the research methodology also involved a literature review and database searches. Finally, the objective is to challenge the traditional principles and conclude with a view as to whether those policy reforms can be successful or not.

The approach followed is a combination of a comparative method with a critical and theoretical review analysis.

1.7 Research questions

- What are the key requirements of a balanced tax system that justifies the imposition of tax?
- What measures are currently in place to avoid double taxation and are these still effective?
- What are the requirements for SA tax authorities to claim taxing rights on non-residents?
- What are the challenges faced by states including SA with the development of e-commerce?
- What are the weaknesses in international rules and policies in relation to permanent establishments?
- What reform steps and actions have been proposed by the OECD to address the weaknesses and promote tax certainty?
- Is there consensus amongst sufficient countries, to the OECD's proposed changes, for the OECD to earn its status of legitimacy as a world tax organisation?
- Are the proposed changes to the concept of PE warranted or should the concept be abandoned?
- Will complexity and the inconsistencies of proposed tax system changes adopted by countries not give rise to increased exploitation of flawed tax rules pertaining to cross-border trade? and
- What are the alternative solutions to address e-commerce tax challenges?

1.8 Structure

To examine and appropriately respond to the questions in paragraph 1.7 above, the research is structured as follows:

Chapter Two contains an overview of the fundamentals applicable to a sound tax system. The objective is to later illustrate that whatever tax reforms are developed should be tested against these fundamentals and rules to ensure fiscal sovereignty of countries, a fair sharing of the tax base and avoid double taxation and non-taxation.

Chapter Three contains a historic overview of principles applied in South Africa as well as the transformation thereof over the years.

Chapter Four deals with International Tax principles relevant to this study and specifically Articles 5 and 7 of Double Taxation Agreements, the Model Tax Conventions issued by the OECD, UN and US in interpreting tax treaties. It also demonstrates how it forms part of South Africa's customary international law on the basis of its acceptance in South African domestic law and case law.

Chapter Five deals with the threat to the tax base of countries which prompted the OECD BEPS Project and reform initiatives.

Chapter Six shares insights into the characteristics of e-commerce and the complexity in applying existing tax principles and measures.

Chapter Seven concludes with a closer look at the features of the permanent establishment concept and contains a critical analysis of the principles contained in the reform proposals, formulated by the OECD and tests that against sound fundamentals for tax certainty. This chapter also includes a view on the rhetorical question of whether BEPS can effectively be countered with tax reforms, specifically with regard to the final reports on Actions 1 and 7 of the BEPS Project formulated by the OECD.

Chapter 2

Fundamental Principles of Taxation

2.1 Introduction

Charles M Allan wrote¹ that taxes are not raised to finance government spending, *even though in some countries this may be the motive*, (my emphasis) but rather for a government to deliver the social goods and reduce the reliance on private sector investment.

Tax is defined as a “**compulsory contribution to the state’s funds**. It is levied either directly on the taxpayer by means of income tax, capital gains tax...”²

Black’s Law Dictionary defines the term as “A monetary charge imposed by the government on persons, entities, transactions or property to yield public revenue.”³

Over the years’ tax policies and the imposition of taxes have been developed primarily to raise essential revenue in order to address domestic economic and social concerns. However, tax system developments over time were also necessitated to keep abreast with globalisation and international trade. Today one of the biggest challenges is for countries to protect their tax base and guard against the shifting of profits to other jurisdictions.

In the South African context, Section 213 of the Constitution of the Republic of South Africa provides for the establishment of the National Revenue Fund and Section 5 of the Income Tax Act provides for the imposition of income tax for the benefit of the National Revenue Fund.

¹ Charles M. Allan, *Theory of Taxation*, published by Penguin, 1971 as quoted by RC Williams, *Income Tax in South Africa, Cases & Materials*, Fourth Edition, @5 a reference work of tax principles and case law.

² Oxford, *A Dictionary of Law A Dictionary of Law (8 ed.)*, Edited by Jonathan Law, Publisher: Oxford University Press
Published online: 2015 Current Online Version: 2016 eISBN: 9780191744402.

³ *Black’s Law Dictionary, Eighth Edition*, BA Garner as Editor in Chief, published by West, a Thomson business.

Not every duty, charge or levy imposed by government is a national tax as the Constitutional Court decided in the *Shuttleworth* case.⁴ Shuttleworth, a South African, emigrated to the Isle of Man in 2001 and in conflict with exchange control regulations transferred a substantial amount of money out of the country without the necessary authorisation. The Reserve Bank, acting on behalf of the Minister of Finance, imposed a ten per cent ‘exit charge’ on the capital. In argument, it was submitted on behalf of Shuttleworth (the Respondent) that the exit charge constituted a ‘tax’ and as such the imposition thereof was not provided for by the Constitution. Deputy Chief Justice Moseneke, in giving the majority judgment, held that the Supreme Court of Appeal erred when it concluded that the dominant purpose in imposing the exit charge was to raise revenue in the form of a tax. The ‘exit charge’ is not a tax and therefore does not have to be imposed by law as is required in Section 213 of the Constitution.

2.2 Fundamental principles of an effective tax system

In an overview report with the aim of reaching consensus on the tax treatment of e-commerce, since the Ottawa Conference in 1998, it is stated that a taxation framework should ensure that taxpayers, “pay the right amount of tax, in the right jurisdictions and at the right time.”⁵

2.2.1 From an international perspective, the OECD confirmed the fundamental principles established in 1998, known as the Ottawa Taxation Framework Conditions which sets out the widely-accepted guidelines underlying tax policy in general and these are:

- Neutrality;
- Efficiency;
- Certainty and simplicity;
- Effectiveness and fairness, and

⁴ *South African Reserve Bank v Shuttleworth*, 2015 ZACC 17

⁵ OECD, *Taxation and Electronic Commerce, Implementing the Ottawa Taxation Framework Conditions, 2001*, Preface by the Chair (Gabriel Makhlouf) of the Committee on Fiscal Affairs, *Electronic Commerce: Realising the Potential*

- Flexibility.⁶

2.2.2 In the Second Interim Report by the Katz Commission, in defining the Commission's approach to its mandate on tax reforms for South Africa, it was stated that a new tax can be justified if one or more of the following factors are present:

- “the revenue that it is likely to yield is significant;
- it has a low cost of administration and compliance;
- it is equitable; and
- it is necessary to meet certain defined political perceptions.”⁷

The Katz Commission went on to list the objectives which should be incorporated in a balanced tax system. It must be borne in mind and in view of this report, that the objectives were recorded at a time before exchange controls were lifted and an overall bias towards a cautious approach of protectionism is clearly evident. The five most relevant fundamentals for purposes of this study are:

2.2.2.1 First and foremost, the function must be to raise revenue for the state;

2.2.2.2 Tax neutrality must be the cornerstone in order to promote international trade and investment without discrimination, that is to say, investment decisions should not be made with reference to tax considerations. The desired outcome should be that foreign and local businesses should ideally be competing on an equal footing;

2.2.2.3 A primary consideration will always be for a country to do what is best for its economy and which under certain circumstances may force a slight bias towards a tax system that protects a country's tax base, thus discouraging an outflow of capital and resources;

⁶ OECD *Addressing the tax challenges of the digital economy*, 2014, Chapter 2 Fundamental principles of taxation, para 2.1 at 30 – 31.

⁷ Issued on 28 June 1995, Chapter 1, Introduction, para 1.6.6.

2.2.2.4 A clear and predictable system which uses recognisable international tax concepts and terminology will support commercial efficacy and mobilise support for foreign trade and investment; and

2.2.2.5 A tax system should be effective to administer and ensure an efficient collection process.⁸

Two of the key tax reform measures proposed by the Katz Commission were that 'active' income which is income derived from operational activities should be taxed on a source basis and 'passive' income, that is to say, income normally derived from investments, needs to be taxed on a worldwide basis. According to the Commission this would enhance international compatibility especially if concepts and terminology of the OECD were to be adopted.

2.2.3 The Davis Committee reported that a respectable tax system should demonstrate the following qualities:

2.2.3.1 Achievement of economic efficiency through charging tax at low rates and to a broad base;

2.2.3.2 Administrative efficiency that requires less resources with reduced administrative and compliance costs;

2.2.3.3 Create equity through an 'ability to pay' and the 'benefit' principle whereby the tax burden is apportioned to taxpayers based on the benefits they receive from government;

2.2.3.4 Fairness of the tax system with regard to the procedure followed and not to discriminate;

2.2.3.5 A system that is clear and easy to understand; and

2.2.3.6 All taxes in a system should be viewed holistically and balance the fiscal policy objectives with the required qualities of a 'good' system.⁹

⁸ 5th Report – *Basing the South African Income Tax System on the Source or Residence Principle* – Options and Recommendations, Chapter 3, para 3.1.

⁹ Davis Tax Committee, *Executive Summary of the Second and Final Report on Macro Analysis of the Tax System and Inclusive growth in South Africa*, April 2016, at 4.

2.2.4 Taking into account what has been listed above as features of a well composed tax system and in addition to what the authors stated in Cyberlaw, this study records that an effective tax system has to have at least the following fundamentals:

- 2.2.4.1 A clearly defined jurisdiction or geographic territory for a state to levy tax, that is to say, a clear demarcation and reach of a state's taxing rights;
- 2.2.4.2 The attributes of the taxpayer and the circumstances under which the subject will be responsible for tax must be clear in order to create certainty;
- 2.2.4.3 There has to be sufficient evidence and information readily available of any such transaction that gives rise to taxation;
- 2.2.4.4 An efficient and affordable mechanism to collect the tax;
- 2.2.4.5 Establishment of a clear and sustainable tax base;
- 2.2.4.6 Sufficient economic activity must exist in order to generate and justify the levying of the tax;
- 2.2.4.7 The justification to tax, that is to say, the *nexus* or connection in terms of which:
 - the state has either contributed infrastructure and facilities enabling the process of income production giving rise to the tax, or
 - the country has contributed to the abilities of the taxpayer producing income or in the alternative, a notion of social contract;
- 2.2.4.8 The tax needs to be certain and not arbitrary;
- 2.2.4.9 The tax has to have the effect of economic and administrative efficiency; and
- 2.2.4.10 There has to be a sound basis of tax fairness or equity in that the liability to pay the tax has to be aligned with the respective ability to afford the payment of the tax.

2.3 Meaning of tax jurisdiction

Ferreira-Snyman in defining ‘sovereignty’ refers to Fassbender who explains the term as meaning the rights and obligations awarded to a state and protected by the principle of public international law.¹⁰ This legal status thus provides for the judicial system of a country to enforce laws over its residents or citizens (individuals and corporates) and all activities that may occur within the territory under its control. It follows that the jurisdiction to enforce legislation is thus essentially territorial.

With reference to the decision of the House of Lords in the *Taylor* case¹¹, the SCA referred to the ‘revenue rule’ which empowers a State with autonomy to enforce a claim for taxes based on its sovereign privileges. In the absence of a permissive provision to the contrary, the revenue rule will prevail, which according to the SCA forms part of South African law. The SCA stated the meaning thereof as “...that the courts of one State are precluded from entertaining legal proceedings involving the enforcement of the revenue laws of another State – an attribute of sovereignty.”¹²

A tax jurisdiction is defined as “An area, city, municipality, county, country with its own distinct regulations for taxation”.¹³

The jurisdiction to tax according to International Commercial Tax is based on the doctrine of ‘economic allegiance’ that is, “...a particular government has no justification, no jurisdiction to tax unless there is an appropriate connecting factor, i.e. a recognised basis of economic allegiance.”¹⁴

10 MP Ferreira-Snyman, *The Evolution of State Sovereignty: A Historical Overview*, a contribution that is based on research done for the author’s PhD thesis, entitled *The Erosion of State Sovereignty in Public International Law: Towards a World Law?* 2006 (12-2) *Fundamina*. Reference taken from Fassbender “Sovereignty and constitutionalism in international law” in Walker (ed) *Sovereignty in Transition* (2003) 115.

11 *Government of India, Minister of Finance (Revenue Division) v Taylor and another* [1955] AC 491; [1955] 1 All ER 292 (HL) at 299.

12 *Krok v CSARS* (20230/2014 and 20232/2014) [2015] ZASCA 107 at 16.

13 *The Law Dictionary*, Featuring Clack’s Law Dictionary Free Online Legal Directory, 2nd Edition, thelawdictionary.org/tax-jurisdiction.

14 *International Commercial Tax* by P Harris and JDB Oliver, 2010, published by Cambridge University Press, at 43.

2.4 Taxing rights

The starting point, according to Olivier and Honiball, to determine whether income is taxable in a country is to consider if the domestic law of that country provides for a *nexus* between the income and the country. The jurisdictional connection may be established where the person (used in a wide sense) who receives the income is connected to that country by way of residency (residence jurisdiction) or the activities that give rise to the income (source jurisdiction).¹⁵ These principles are dealt with in more detail in Chapter Three below.

The general rule of international tax treaties according to Oguttu and in accordance with Article 7(1) of the OECD MTC is that a non-resident taxpayer will only be subject to tax on its business profits to the extent that such profits are attributable to a permanent establishment situated in that country¹⁶

2.5 Conclusion

An attempt to impose tax on business profits generated through e-commerce activities of a non-resident enterprise may be challenged by the following features that justify a sound tax system,

- The administration of taxation may prove to be inefficient and not effective without increased resources and advanced technology,
- The yield to the *fiscus* may be insignificant.
- The administration and collection process may be costly,
- An appropriate mechanism to comply and collect the tax will have to be created,
- Information to support sufficient evidence to levy tax, may be difficult to obtain, and

¹⁵ L Olivier and M Honiball, *International Tax, A South African Perspective*, 2011, Fifth Edition, Published by Siber Ink, at 9 and 10.

¹⁶ AW Oguttu, *The Challenges of Taxing Profits Attributed to Permanent Establishments: A South African Perspective*, (2009) 21 SA Merc LJ 773; OECD (2015), Model Tax Convention on Income and on Capital (2014) Full Version, OECD Publishing.

- To define the jurisdiction to justify taxing rights (*nexus*) may be problematic.

Oguttu stated, "...before a country can level tax on income derived nationally or internationally, a connection (basis), or 'tax nexus' must be established between the country and that income."¹⁷ According to the author, this required connection is established by either a physical or legal presence in a country.

¹⁷ AW Oguttu, *International Tax Law: Offshore Tax Avoidance in South Africa*, 2015 at 67.

Chapter 3

Overview of Basic Taxation Principles

3.1 Introduction

Fundamentally, for income to be taxable in a specific country, there must be a connection or tax *nexus* between the income and the country and this connection may relate to either residence or source.

As a general rule and applied across the world, a business enterprise is subject to tax in the country where such entity is formally registered as well as to the country in whose jurisdiction it may have a permanent establishment. It follows that in order to determine whether income, derived by or accrued to an entity, is taxable under the domestic laws of a particular country, one has to identify whether a *nexus* or connection exists between the income generated and that country.

Whilst the right to tax is a sovereignty principle that gives a country the authority to tax those who are resident therein, it also allows tax to be imposed on foreigners based on the physical *nexus* in the form of a permanent establishment that a foreign entity may have to a country of source.

The *nexus* issue for both the residence and source taxation of business profits was considered in detail by the OECD and is covered in Chapter Four below.

Olivier and Honiball state that “These connecting factors are referred to as ‘**residence** jurisdiction’ and ‘**source** jurisdiction’ and are closely linked to the principle of sovereignty, in other words the principle that a nation has sole jurisdiction over its own territory or subjects.”

3.2 Tax principles in South Africa

Section 5 of the Income Tax Act serves as authority to impose income tax in South Africa.¹ The tax system in South Africa turns primarily on the definition of 'gross income' as defined in section 1 of the Act which serves as the key starting point to determine a tax liability.^{2,3} In brief terms 'gross income' which is a statutory concept contains the following elements that have been well recognised and laid down in case law over the years:

- The liability for tax falls on either a resident or any person other than a resident, in which case the judiciary meaning of 'source' has to be considered;⁴
- The total amount may be in cash or otherwise;
- The amount must be received by or accrued to or in favour of the resident or any person other than a resident;
- The element of time reflects on the amounts accrued during a year of assessment;
- The element of quality excludes any amount of a capital nature; and
- Specific inclusions as listed in the definition.

For purposes of this study the research is limited to the relevant and critical concepts of 'resident', 'source', 'permanent establishment' and 'place of effective management' pertaining to e-commerce and these concepts are examined in more detail below. This study is further restricted primarily to legal persons or persons other than natural persons, as is referred to in the Act.

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

2 Section 1 of the Income Tax Act no 58 of 1962, as amended.

3 Income Tax Act no 58 of 1962.

4 Resident as defined in the Income Tax Act no 58 of 1962.

It is also essential to note that the definition of ‘gross income’ specifically refers to and draws the distinction between a ‘resident’ and ‘any person other than a resident’. When one then refers to the definition of ‘resident’ it includes both a natural person and also a ‘person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic.’ It follows that in order to draw a distinction between an individual and that of a juristic person one has to first resort to the inclusive definition of ‘resident’.

Under previous versions of the definition of ‘gross income’, the term ‘person’ was used as opposed to ‘resident’. As the term ‘person’ is not defined in the Income Tax Act, one had to revert to the Interpretation Act 33 of 1957 which Act applies to the interpretation of every law, where one finds under section 2, Definitions, that ‘person’ includes:

- “(a) any divisional council, municipal council, village management board, or like authority;
- (b) any company incorporated or registered as such under any law;
- (c) anybody of persons corporate or unincorporate;”⁵

From this definition, it is clear that the term is not restricted to natural persons and the reason for the legislature using the all-inclusive term of ‘person’ was that South Africa at the time followed the sourced-based system of taxation and only amounts from a source within or deemed to be within the Republic were included.

3.3 History of principles applied in South Africa

3.3.1 From 1914, the tax system was primarily sourced-based which as a general principle levied income tax on income from a source within or deemed to be within the Union of South Africa.⁶ Irrespective of the residency of a taxpayer,

5 INTERPRETATION ACT 33 OF 1957, Gazette No. 5876, Notice No. 771, dated 24 May 1957. Commencement date: 24 May 1957.

6 The Income Tax Act 28 of 1914.

the definition of gross income provided for all income that was derived from a source within the Union to be included.

- 3.3.2 In 1951 the Steyn Committee did not support any change with regards to these principles and recommended that the source basis of taxation be retained.⁷
- 3.3.3 The Franzen Commission, however, recommended in 1970 the abolishment of source-based taxation.⁸ Although the Government accepted the Franzen Commission's recommendation, it was never implemented. The period 1962 to 1977 saw the continuance of the sourced-based system with receipts and accruals of income derived from a source within the Republic of South Africa or from a source deemed to be within in the Republic being subject to tax. As a consequence, non-residents paid income tax on their South African sourced income.
- 3.3.4 During 1986/1987 the Margo Commission recommended that the source basis of taxation be retained.⁹ The Commission was of the view that due to the complexity of administering a residence-based system and the restricted net fiscal benefits to be derived from such worldwide system it would not be in the beneficial interest of the tax administration to change. The report, in paragraph 26.2 thereof nevertheless recognised the importance of international trade and noted the importance of South Africa's attempts to re-integrate with the global economy:

“The Republic has an open economy and seeks to create an environment that will attract investments and facilitate trade. A hospitable fiscal environment is seen as an integral part of such endeavours. Transnational corporations are making valuable contributions to the growth of developing countries through their inputs of expertise and capital, and they should be encouraged.”

7 First Report of the Committee of Enquiry into the Income Tax Act, The Steyn Committee Report, Union Gazette No 75 – 1951, Government Printer, para. 68, at 19.

8 Commission of Enquiry into fiscal and monetary Policy in South Africa, The Franzen Commission Report, Taxation in South Africa: Second report, RP 86/1970, The Government Printer 1970, para. 20.

9 Report of the Commission of Inquiry into the Tax Structure of the Republic of South Africa, The Margo Commission Report, RP34/1987, The Government Printer 1987, para.26-3.

The Commission acknowledged though that a worldwide or residence basis of taxation would have a considerable effect on tax avoidance if exchange controls were to be lifted (which exchange controls were in fact relaxed in subsequent years). The Government accepted the Commission's recommendation and the *status quo* was, accordingly, left unchanged.

3.3.5 The next inquiry into taxation was conducted by the Katz Commission who acknowledged that any tax system and its outcomes must take into account not only domestic, but also international economic objectives when setting rules to subject residents and foreigners to taxes of that country.¹⁰

The Commission proposed a clear distinction between what is termed 'active' and 'passive' income which is terminology that is well recognised in international tax law. This division serves to illustrate that 'active' income which is derived from a direct and operational activity in a country, should be taxed on a source basis and 'passive' income which relates to income which is not active income, for example passive forms of investment on which interest and/or dividends are earned, should be taxed on a world-wide basis. Support for this proposal was gained from the Commentary by the OECD Committee for Fiscal Affairs on the OECD Model Double Taxation Convention on Income and Capital.

3.3.6 When exchange controls were relaxed with effect from 1 July 1997, changes to South Africa's position in the arena of the international economy called for the protection of South Africa's tax base in order to broaden the country's tax base. In the same speech that the Minister of Finance announced Capital Gains Tax, it was unveiled that South Africa would with effect from 1 January 2001 change from a source-based system to a resident-based principle of income tax for South Africa residents.¹¹

3.3.7 It was followed by changes to the definition of 'gross income' to ensure that residents as defined are taxed on their world-wide income notwithstanding the

¹⁰ 5th Report of the Commission of Inquiry under chairmanship of Prof MM Katz into taxation in South Africa, established on 22 June 1994.

¹¹ Proceedings of the National Assembly, Wednesday 23 February 2000, Budget Speech delivered by the Minister of Finance, Trevor A Manuel.

source.¹² Non-residents, however, continued to be taxed in South Africa on income derived based on the source principle. Today, the determination of residence is the first and vital test with regards to the taxation of income and is also referred to as the ‘residence-minus’ system which means that SA residents are taxed on their world-wide income, minus certain classes of income from activities outside South Africa, which may be exempt. The current system is often referred to as a hybrid of source and residence basis in that non-residents are subjected to tax on income from a South African source. Both these systems apply to natural and juristic persons.

3.3.8 Today, the definition of ‘gross income’ incorporates amounts received by or accrued to residents (as defined) and relates also to non-residents and the amounts received by or accrued to them from a source within the Republic. These concepts are examined in more detail below.

3.4 An analysis of the relevant principles in a South African context

The Appellate Division compared the rationale for residence-based to that of a sourced-based principle and observed that:

“In some countries residence (or domicile) is made the test of liability for the reason, presumably, that a resident, for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him. In others (as in ours) the principle of liability adopted is ‘source of income’; again, presumably, the equity of the levy rests on the assumption that a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live. In both systems, there is of course, the assumption that the country adopting the one

¹² See examination of the resident principle in 3.3.1 below.

or the other has effective means to enforce the levy.”¹³

3.4.1 Resident and Place of effective management

3.4.1.1 Meaning

The Revenue Laws Amendment Act of 2000 introduced a definition of ‘resident’ as applicable to a legal person in section 1 of the Act and it means any:

“(b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic,”.¹⁴

A ‘foreign company’ is defined in the Act to mean any company which is not a resident. This means by implication that a juristic person, although incorporated in any country other than South Africa, may be a resident for South African income tax purposes if it has its place of effective management in the Republic.

In general, when one considers the resident-based principle the criteria is first and foremost residency and once that has been established, income on a world-wide basis will be taken into account.

Only once a taxpayer has been established to be a resident, will all income accruing to such a taxpayer as a resident be subject to tax in South Africa. The definition contains two statutory tests or criteria to determine residency, the first being the incorporation or establishment and the second and alternative test is the place of effective management. Whilst the place of incorporation or establishment is elementary and evidenced by an administrative and regulatory formality (a *de jure* test), it is the place of effective management (which is a question of fact) which has caused much debate.

There is no definition in the Act as to what ‘place of effective management’ means and one has to revert to other sources of legal authority for the interpretation of this concept. Several legal principles relating to the concept of ‘place of effective

¹³ Kerguelen Sealing & Whaling Company Limited v CIR 1939 AD 487; 10 SATC 363, at 380.

¹⁴ Act 59 of 2000, section 2(h).

management' have been adopted by South African courts as is discussed below. It is relevant for purposes of this study to note that it has been held that the place of effective management is where the actual operations which earn a profit occur. The carrying on of a trade through agents in a country does not constitute residence, but it may be decisive to constitute a permanent establishment. This 'agency arrangement' has received considerable attention from the OECD BEPS Project in that a *commissionaire* arrangement whereby products are sold by an agent on behalf of a foreign enterprise is seen as a means to erode the taxable base of the state where the goods or services are being sold. (See Chapter Five for more detail).

As it is possible under most treaties for a legal person to be resident in two countries the 'management' test (also commonly referred to as a 'tie-breaker' rule) serves to prevent (or at least that is the objective) a legal person from being deemed resident for purposes of a tax treaty in both contracting states.

In the event of potential double taxation, that is to say, where the same income may be taxed in the hands of the same taxpayer by two countries applying their respective domestic tax rules, for example being regarded a resident of both countries, does one have to seek relief in terms of the tax treaty between the two contracting states. The meaning of 'resident' as it appears in model tax conventions and most tax treaties (Article 4), is covered in Chapter Four below. In this regard, the OECD Commentaries adopted a so-called 'tie-breaker' rule that, "The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made."¹⁵ Although used commonly in tax treaties, Oguttu reminds us that there is no consistent international interpretation.¹⁶

Du Toit concludes that,

¹⁵ OECD, *Commentaries On The Articles Of The Model Tax Convention (Condensed Version)* 2010, paragraph 24 of the Commentary on Article 4, at 88.

¹⁶ AW Oguttu, *International Tax Law, Offshore Tax Avoidance in South Africa*, 2015, at 78.

“...it is clear that POEM features in two different contexts in the realm of South African tax legislation, being in the context of determining tax residency under the Income Tax Act 1962 and as a tie-break clause in various DTAs to which South Africa is a Contracting State.”¹⁷

3.4.1.2 Case Law

The fundamental principle of residence in respect of persons other than natural persons was originally laid down in the *De Beers Consolidated Mines Ltd* case wherein the Court held that “a company resides for purposes of income tax where its real business is carried on ... and the real business is carried on where the central management and control actually abides.”^{18,19} This ruling was followed in the *Rhodesia Railways* case and adopted by South African courts.²⁰

In later years in the Appellate Division Watermeyer JA held that the term ‘residence’ for purposes of a company was similar to the concept used in relation to a natural person and “the residence of a corporation will be determined by the periodic, usual or habitual location of the directing mind.”²¹ The ruling laid down in the *De Beers* case was also followed and confirmed in *Boyd v CIR* wherein the Appellate Division decided that “the legal persona is resident in the Union, where its central management and control abides.”²²

The *De Beers* ruling was also accepted by the English Court of Appeal and the Court *a quo* in *Wood and Another v Holden* wherein the Courts had to decide whether a company incorporated in the Netherlands and managed by a Dutch trust company was resident in the United Kingdom.²³ In this instance the UK Authorities contended that the trust company merely took instructions from PriceWaterhouse in London. The Court of Appeal found that in order to determine where the central management

17 Du Toit, JM, *Place of Effective Management – Who calls the shots?* Master of Commerce, Research Report, University of the Witwatersrand, 2015.

18 *De Beers Consolidated Mines Limited v Howe* 1906 AC 455.

19 *ibid*, at 459.

20 *Rhodesia Railways and Others v COT* 1925 AD 439

21 *Estate Kootcher v CIR* (1941) AD 256, at 260.

22 *Boyd v CIR* (1951) 3 SA 525 (A) at 535.

23 *Wood and Another v Holden (HMIT)* 2006 [ECWA Civ 26].

and control lies it is important to distinguish between where management and control is exercised by the board and those instances where the functions of the board are fulfilled by independent intermediaries or ‘outsiders’ without having regard to the board as constitutional structure.²⁴ In finding that the Court *a quo* was correct, the Court of Appeal concluded that the Dutch company was resident in the Netherlands. The principle of ‘central management and control’, laid down in *Wood v Holden* was confirmed as the true rule in *Laerste BV v HMRC*.²⁵

Several Courts also rejected the issue that a company could be resident in more than one country.²⁶ Watermeyer JA concluded that “a corporation cannot acquire a residence in a country merely by carrying on trade through agents in that country.”²⁷

In a more recent case decided in the Cape High Court the issue was whether the taxpayer, a trust established and registered in Mauritius and represented in this matter by its trustee that was also incorporated in Mauritius, was resident in the Republic based on the grounds that it had its effective place of management in South Africa. The core question before the Court in the *Oceanic Trust* case was whether “key management and commercial decisions that are necessary for the conduct in question were in substance” made in South Africa or Mauritius.²⁸ Based on a factual finding the Court concluded that sufficient key decisions based on substance were made in South Africa and held that the taxpayer, notwithstanding having been established and registered in Mauritius, was resident in the Republic because it had its place of effective management in South Africa.

Counsel for the taxpayer, in addressing the meaning of place of effective management, relied on a minority judgment of the England and Wales Court of Appeal and submitted that the place of effective management is at “...the centre of top-level management: that is to say, where the key management and commercial decisions are actually made.”²⁹ Counsel submitted that the management of the

²⁴ *ibid*, paragraph 27.

²⁵ *Laerstate BV v HMRC* [2009] UKFTT 209 (TC).

²⁶ *Rhodesia Railways and Others v COT* (1925) AD 439 and *Estate Kootcher v CIR* (1941) AD 256.

²⁷ *Estate Kootcher v CIR* (1941) AD 439 at 262.

²⁸ *The Oceanic Trust Co Ltd NO v CSARS* (2012) 74 SATC 127 (Western Cape High Court).

²⁹ *Commissioner for Her Majesty's Revenue and Customs v Smallwood* (2010) EWCA Civ 778, delivered on 8 July 2010.

taxpayer had been in Mauritius and that no decision by the applicant (in this case) as trustee of the taxpayer, had been taken in South Africa.

The Supreme Court of Appeal acknowledged that the resident status of Tradehold Ltd, incorporated in South Africa, changed when a board resolution was passed for all future board meetings to be held in Luxembourg.³⁰ As a result, Tradehold ceased to be a resident of the Republic and turning to Article 4(3) of the DTA between South Africa and Luxembourg, the Court acknowledged that the deemed place of residence is located in the country where the effective management of a company takes place.

Williams summarised the key features of the England and Wales Court of Appeal case in terms of which the following extracts are relevant for purposes of this study (*my emphasis*)

- “...the **place** where **key** management and commercial **decisions** ...are in substance **made**;”
- “...will ordinarily be the **place where the most senior group of persons** (e.g. a board of directors) **makes its decisions**, where **the actions to be taken** by the entity as a whole **are determined**;”
- “There may be **more than one place** of management, but **only one place of effective management at any one time**;”³¹

In summary, it appears that to determine ‘place of effective management’, primary decisions concerning the actions of an entity need to be made by key and senior management at a specific place.

3.4.1.3 Interpretation by SARS

Practice Note 7 of 1999 still referred to “managed or controlled” as the test for residency relating to legal persons.³² The terms “managed and controlled, “and ‘effectively managed’ were, however, used inconsistently and since the change in

³⁰ *Commissioner for the South African Revenue Service v Tradehold Ltd* (132/11) [2012] ZASCA 61.

³¹ *Income Tax in South Africa, Cases & Materials* by RC Williams. Fourth Edition, LexisNexis, at 26.

³² Practice Note 7 dated 6 August 1999, para 1.1.3.

the definition introduced in 2000, SARS issued Interpretation Note 6 in 2002 to deal with the interpretation of the concept of ‘place of effective management’.³³ According to SARS’s interpretation the place of effective management is “...where the day-to-day operational management and commercial decisions taken by the senior managers are actually implemented...”.

The reason for the interpretation note, according to Malan, was to align SARS’ approach to that of international jurisprudence and establish legal certainty.³⁴

The principles laid down in the *Oceanic Trust Case* have since been incorporated in the SARS’s recent and second version of Interpretation Note 6, which replaces the controversial first issue.^{35,36} The key factor now, according to SARS, is to locate the place at which key management and commercial decisions that are necessary for the conduct of the business as a whole are made. In the event of these key decisions being taken at more than one place, the primary or predominant decisions should determine effective management. Recognising the developments in information technology and global travel, SARS acknowledges that one should not place excessive focus on the actual location where meetings take place, but rather consider the facts and circumstances of each case.³⁷ Should meetings be conducted via telephone or video-conferencing, then effective management will be where decisions are taken by those with the highest decision-making authority.

It should be noted that interpretation notes do not carry the status of law and merely represent SARS’ interpretation of the law.

3.4.1.4 Katz Commission

It was the Katz Commission which recommended that the concept of ‘managed and controlled’ as it was used in the definition at the time, be replaced with ‘effective

33 Interpretation Note 6: “effective management”, SARS, 26 March 2002.

34 Daleen Malan, *SARS’ new draft interpretation note*, 17 June 2015, accessed on www.thesait.org.za/news/237163/SARS.

35 See footnote 45.

36 Draft Interpretation Note 6 (issue 2): “*place of effective management*”, SARS, released on 31 July 2015.

37 Paragraph 4.2.4 of Practice Note 6 (issue 2), released on 31 July 2015.

management’ as referred to in OECD Model Convention due to the fact that the concept of managed and controlled is open for manipulation by multi-national corporations conducting business in more than one jurisdiction.

3.4.1.5 Applying the attributes of the place of effective management principle to e-commerce

From the outset, it should be noted that with the use of technology, the **place** where decisions are taken or a company is **effectively managed** for purposes of e-commerce can still be manipulated to ensure that effective management is undertaken in a low or no tax territory. Furthermore, with e-commerce the principles of incorporation, establishment, formation or place of effective management may prove that there are serious anomalies in the present statutory criteria to determine residency which in turn negates the legal concept of gross income.

Discussing the challenges that e-commerce pose to legislation and more specific the concept of ‘place of effective management’, Oguttu says that electronic cross-border trade may result in it being, “...possible to avoid the ‘place of effective management’ jurisdictional requirements that are based on geographical location.”³⁸

E-commerce is described in *Cyberlaw @ SA* as trade and commercial activities by multi-territorial entities without having a traditional residence.³⁹ It follows that an attempt to enforce conventional rules of residency to business enterprises transacting and rendering online services to customers in South Africa via Internet will fail if these enterprises have no location in South Africa **‘where the central management and control actually abides’** or **‘a location in SA of the directing mind’**. Furthermore, it is submitted that a foreign enterprise conducting e-commerce business in South Africa does not constitute ‘residency’ following the rule that a

38 AW Oguttu, *International Tax Law, Offshore Tax Avoidance in South Africa*, 2015, at 519.

39 S. Papadopoulos and S. Snail (Editors), *Cyberlaw@SA III: the law of the Internet in South Africa*, Third edition at 103.

‘corporation cannot acquire a residence in a country merely by carrying on trade through agents in that country’. The **‘place where key management and commercial decisions ...are in substance made’**, or the **‘place where the most senior group of persons (for example a board of directors) makes its decisions’**, or where **‘the actions to be taken by the entity as a whole are determined’** as common law guidelines may prove inadequate to legally constitute residency. (my emphasis) I am of the view that residence as a *nexus* has lost its persuasive importance with regards to e-commerce as the characteristics of the digital economy prove that often only limited activities of an enterprise take place in the country of residence.

A website, webpages, servers, computer equipment, hosting arrangements and Internet Service Providers (ISP) used by way of a combination of software and electronic data to conduct e-commerce in a particular country does not in itself constitute a ‘person (other than a natural person)’ and, hence, it cannot be said to be a ‘company’ -as defined- ‘incorporated’ or to have ‘its place of effective management in the Republic’. It clearly may not meet the requirements of the residency test and as a consequence it is relevant to consider whether inbound e-commerce may be subject to tax under the source rule.

3.4.2 Source

3.4.2.1 Meaning

The Act does not define ‘source’ and to determine what the meaning is of the concept ‘from a source in the Republic’, one has to revert to the judiciary meaning as laid down in case law.

As a general rule the source-based principle ascribes taxing rights to a country by virtue of the fact that activities which give rise to the income, take place within that country’s jurisdiction.⁴⁰ Today, the principle of ‘source’ remains relevant for persons (used here in a wide sense) who are not ‘resident’ in South Africa as they will be subject to tax on income from a ‘source’ in the Republic. According to Williams,

⁴⁰ *International Tax, A South African Perspective 2011*, by L Olivier and M Honiball, 5th edition, at 11.

source means the originating cause giving rise to the income and once that cause has been established one must determine whether the location of that cause is in South Africa.⁴¹ It follows that in applying the general principle, the question to be answered should not be where does the income come from, but rather, what initiates the income? The answer to that is a practical matter of fact. It has often been said that it is ‘the work that the taxpayer does’ to earn the income or the *quid pro quo* for receiving the income.

In applying the source-based principle, the key condition is that income needs to originate within the territorial or geographic borders of a country.

3.4.2.2 Case Law

It was in 1926 that the Court mentioned that source meant origin and not location.⁴² It was only in later years, however, in a landmark case that the principle of ‘source’ was established in *CIR v Lever Brothers & Unilever Ltd*, in terms of which the Court ruled:

“the source of receipts, received as income, is not the quarter whence they come but the originating cause of their being received as income and that this originating cause is the work which the taxpayer does to earn them, the *quid pro quo* which he gives in return for which he receives them”.⁴³

The Court introduced the two-steps test which remained unchallenged for 54 (fifty-four) years until it was superseded by legislation (residents to be taxed on world-wide income), which proves to be the difficulty for the legislature in defining the concept as alluded to by Centlivres CJ in *CIR v Epstein*.^{44,45} The test in *Lever Bros* requires firstly the determination of the originating cause and then locating that cause.

41 *Income Tax in South Africa, Cases & Materials* by RC Williams, Fourth Edition, LexisNexis, at 39.

42 *Overseas Trust Corporation Ltd v CIR* 1926 AD 444, (2 SATC 71) at 453-4.

43 *CIR v Lever Brothers & Unilever Ltd* 1946 AD 441, (14 SATC 1) at 454.

44 Definition of ‘resident’ inserted by section 2(h) of Act 59 of 2000.

45 *CIR v Epstein* 1954(3) SA 689 (AD), (19 SATC 221) at 698.

However, establishing the source of income has over the years and still today poses considerable controversy. Williams highlights some of the difficulties.⁴⁶ What if a combined number of factors give rise to the originating cause or the originating causes take place in different countries? This is relevant for purposes of this study and more specifically with regards to the principles and its application to e-commerce.

It was in *Essential Sterolin Products (Pty) Ltd v CIR* that the Court affirms the principle laid down in *CIR v Black* that in the event of several causal factors, it will be appropriate to consider all and determine the dominant and real cause giving rise to the receipts.^{47,48} The appellant, located in South Africa, manufactured medication in an active substance form which was then exported and modified into a generic medicine by a company in Germany. The manufacturing, distribution and sales aspects of the business were conducted through several companies registered in numerous European countries. The Court of Appeal decided that the consideration received was not from a source in South Africa as the consideration was more closely linked to the dominant business factors that occurred predominantly in Europe. In this case the said payment was made due to a re-organisation of the business by the appellant (located in South Africa) and received from a company in West Germany.

For purposes of this study it is also appropriate to note the Courts' judgment in *M Ltd v COT* and *CIR v Epstein* (in a dissenting judgment by Schreiner JA in the latter case) when analysing e-commerce.^{49,50} It was held that it is irrelevant where the taxpayer's principal business is situated. What is of importance is to consider where the taxpayer carries on the business or trade which generates the profits and where those profits are realised.⁵¹

⁴⁶ *Income Tax in South Africa, Cases and Materials* by RC Williams, Fourth Edition, LexisNexis at 39.

⁴⁷ *Essential Sterolin Products (Pty) Ltd v CIR* 1993 (4) SA 859 (A).

⁴⁸ *CIR v Black* 1957 (3) SA 536 (A).

⁴⁹ *M Ltd v COT* (SR) 1958 (3) SA 18 (22 SATC 27).

⁵⁰ *CIR v Epstein* 1954 (3) SA 689 (A) (19 SATC 221).

⁵¹ *Income Tax in South Africa, Cases and Materials* by RC Williams Fourth edition, LexisNexis, at 45.

In the event of multiple sources, the courts have viewed an apportionment of profits as allowable, but due to practical difficulties in allocating profits to different sources may force the rule of a dominant or real source to be applied. It was in *ITC 1491* that the Court found that payment received by a South African based taxpayer for having granted the rights to use a trade mark and formulas in the UK did not accrue to the taxpayer from a source within the Republic.

3.4.2.3 Katz Commission and Davis Tax Committee

The Katz Commission did consider whether a definition of source and its location would be advisable, but decided against a detailed definition of the source concept. The view was held that such a definition may give rise to opportunities for tax arbitrage and the potential of businesses structuring their affairs to avoid tax. The Commission acknowledged though that the means to determine the source of business income was open to more than one interpretation and recommended to introduce the general concept of taxing business profits as contained in international tax conventions and terminology. By following the OECD Model Tax Convention which uses the concept of 'business income' in conjunction with 'permanent establishment', the South African tax system will acknowledge "the notion of business activity through a minimum presence within the taxing jurisdiction."⁵²

The Commission's recommendation was that active income derived from direct and operational activity in a jurisdiction should continue to be taxed on a source basis. The effect thereof is that foreign enterprises operating in South Africa will have to pay tax on the income derived from these activities and pay tax at a rate similar to what domestic businesses pay.

In considering the impact of income derived from e-commerce in South Africa, the Davis Tax Committee acknowledged that the current common law guidelines are inadequate to determine the source of income of the digital economy to be located in South Africa. The report stated that as a consequence thereof there may be no legal basis for the taxation of income derived by non-residents from e-commerce activities with South African consumers.

Referring to an example of companies like Google, the Committee admitted that tax can be avoided in South Africa as the originating cause (source) of their business

⁵² Katz Commission, 5th Report- *Basing the South African Income Tax System on the Source or Residence Principle Options and Recommendations*

profits may not be located in South Africa. For a foreign company to be taxed on its business profits it has to have a permanent establishment in South Africa and due to international challenges in applying the permanent establishment concept to e-commerce, South Africa share the same difficulties. The Committee concluded that it should in making recommendations in this regard and rather to take guidance from the OECD's reform measures.

3.4.2.4 Applying the attributes of the source principle to e-commerce

The traditional enquiry relating to the originating cause of income is linked to the location of a taxpayer's activities, however, with the Internet:

“... e-commerce transactions can generate income without substantially using infrastructure in any given physical location. Information technology has also made it possible for businesses to decentralise and to spread their functions (such as financial, administrative, marketing, sales, delivery and customer support) across various jurisdictions to yield the greatest return on investment and to provide in the need of remote customers.”⁵³

It may be argued, based on the Court's findings in ITC 1491, that a foreign business transacting goods and services with consumers in multiple countries including South Africa via the Internet, may constitute the granting of rights or licences to use intellectual property, whether tangible or intangible products like literature, music, photos, information, data software or code and, hence, based on an apportionment certain profits may be deemed to be from a source within South Africa.

If a web-server hosting a website on which e-commerce is conducted, is not located in South Africa, then arguably the originating cause of the activity is not in South Africa as no 'wit, labour and/or skills are employed within South Africa. In the event of the server being located in South Africa at a fixed place should one test whether that constitutes a permanent establishment? (see para 3.4.3 below). The question to

53 Oguttu and Van der Merwe, *SA Mercantile Law Journal*, 2005, at 313 – 315.

be answered in this instance is whether the server provides the required *nexus* to allocate fiscal jurisdiction to South Africa.

However, applying the general principles as laid down in case law over the years, the submission is, as this study will conclude in Chapter Seven, is that applying substantive income tax rules to e-commerce remains a unique challenge. The question is whether the dominant business factors underlying cross-border e-commerce take place in South Africa and whether the originating cause and the location of that cause could be deemed to be within South Africa?

It is submitted that business profits from e-commerce transactions with consumers cannot constitute a source due to there not being an originating activity in South Africa.

3.4.3 Permanent establishment

3.4.3.1 Meaning

The concept 'permanent establishment' is defined in section 1 of the Act to mean:

“a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor”;⁵⁴

It is to be noted that the PE concept does not in itself allocate taxing rights and is a derivative of the charging guidelines contained in Article 7 paragraph (1) of the OECD Model Tax Convention.⁵⁵ This article provides that only business profits that may be attributed to a PE, may be taxed in the source country. The meaning of the PE concept is reflected in article 5 of the OECD Model Tax Convention, paragraph

⁵⁴ Income Tax Act 58 of 1962, definition inserted by section 5(g) of Act 5 of 2001 and amended by section(1)(v) of Act 7 of 2010.

⁵⁵ OECD *Model Tax Convention with respect to Taxes on Income and on Capital* (Condensed Version) © OECD 2014, at 28.

(1) as “...a fixed place of business through which the business of an enterprise is wholly or partly carried on.”

The primary purpose of the concept of permanent establishment is to determine the source of business profits or taxable presence of an enterprise. Once that has been established may the country of source tax the business profits from those activities that occur in its jurisdiction. Oguttu is of the view that the concept, “...presupposes that there must be ‘a fixed place of business’...”, and a link to, a geographic location.⁵⁶ In other words, when an enterprise crosses the borders of the state in which it was incorporated and starts performing business activities in another state, then the enterprise may be considered to have a permanent establishment in that other state which constitutes a taxable presence based on the source principle.

Even though a company may not have been incorporated, formed or established in South Africa as per the definition of ‘resident’, it may still be subject to tax if that enterprise is deemed to have set up a permanent establishment in the Republic. It is the PE concept that creates the connecting factor or taxable nexus to tax the business profits of a non-resident on the principle of source.

3.4.3.2 Case Law or other

In *Transvaal Associated Hide and Skin Merchants v COT*, the Court had to deal with the issue of determining the dominant cause and potential apportionment.⁵⁷ In his judgment, Maisels JA in dealing with ‘permanent establishment’ with reference to the Double Taxation Agreement between the Government of Great Britain and Northern Ireland and the Government of the Union of South Africa, said:

“As to whether the appellant had a permanent establishment in Botswana, I think the word ‘permanent’ is used in contradistinction to a merely temporary or occasional use of premises for purposes of trade or business.”⁵⁸

⁵⁶ AW Oguttu, *International Tax Law, Offshore Tax Avoidance in South Africa*, 2015 at 535.

⁵⁷ 29 SATC 97.

⁵⁸ *ibid*, at 115 of 29 SATC 97.

Apropos the meaning of 'permanent' it was held, based on the facts of the matter, that the occupation of premises should be described as a state of continuing indefinitely.

How does one deal with a situation where the enterprise uses an agent in the source country? The Court in *SIR v Downing* ruled that conducting a business through an agent who carried on his own business in his own premises does not constitute a 'permanent establishment' as long as the agent is legally and economically independent of the enterprise.⁵⁹

3.4.3.3 Katz Commission and Davis Tax Committee

It was the Katz Commission which recommended that in line with international trends and legal systems the liability to tax by virtue of a permanent establishment should be incorporated in South African tax law.⁶⁰ The Commission favoured the definition of permanent establishment contained in the UN Model Convention as opposed to the OECD Model Tax Convention, the reason for the former being that it allows the source country greater taxing rights under a tax treaty.

For the taxation of cross-border business transactions taking place in South Africa the Commission recommended two criteria as critical in determining a permanent establishment and these are the concepts of **presence** (through a permanent establishment) and **activity**. Once the activity that generates the active income or 'business profits', as it is referred to in the UN Model Convention, has been determined, one should relate that activity to the jurisdiction in which the permanent establishment or place is located.

As the treaty definition refers to a 'fixed place of business', the Commission, with reference to the concept of 'a place', recognised that technology may provide for cases where the place of business is not 'fixed' in the sense of 'established at a

⁵⁹ 1975 4 SA 518A.

⁶⁰ 5th report of the Katz Commission – *Basing the South African Income Tax System on the Source or Residence Principle*, Chapter 5, para 5.3.1.

distinct place with a degree of permanency’ and recommended that it be replaced with a requirement of a ‘business facility suitably qualified.’

It was further acknowledged that only the income that may be attributed to the permanent establishment should be subjected to tax in that jurisdiction.

As the challenge of the digital economy is an international encounter, the Davis Committee opted to wait for the OECD reform measures and not to follow a unilateral approach.⁶¹ The Committee raised its views with respect to taxation of the digital economy which are listed in 6.6 below.

3.4.3.4 Applying the attributes of the principle to e-commerce

Internet has this unique attribute to bring a seller of goods and/or services in contact with multiple buyers without there being a formal engagement other than an electronic interaction.

With Internet as a tool to enable e-commerce between a consumer in one country and the seller or service provider located in another country, there is no need for a physical interface which defuses the object of locating a permanent establishment. The instances listed in Article 5 paragraphs (2) and (3) of the OECD MTC, albeit not an exhaustive list of examples, demonstrate the activities which resemble a PE and are all indicative and attributable to a fixed place or *in situ*, wherein the business enterprise in question has a physical presence at a geographic location in a state.^{62,63}

The view is that the PE concept has a restricted effect on enterprises with a digital business model. It is submitted and will be addressed in more detail in Chapter Seven that the inherent requirement of a physical presence in order to qualify as a permanent establishment has restricted application in solving the tax issues

⁶¹ *ibid*, at 27.

⁶² OECD *Model Tax Convention Commentary*, on Article 5(2), paragraph 12.

⁶³ (n.d.). in the natural, original, or appropriate position, Collins English Dictionary - Complete & Unabridged 10th Edition. Retrieved August 23, 2016 from Dictionary.com website <http://www.dictionary.com/browse/in-situ>.

especially when it comes to e-commerce and digital developments wherein a business is conducted exclusively by means of electronic transactions.

The use of computer equipment in e-commerce was included in the Commentary to Article 5 of the OECD Model Tax Convention and the keynotes are contained in para 6.3 below.⁶⁴

A Budget proposal was submitted in February 2016 to introduce a withholding tax on service fees rendered by non-residents with effect from 1 January 2017. However, the proposal appears to have since been abolished.

It was announced by SARS in 2015 by way of public notice that any arrangement for the rendering of a service by a non-resident to a resident of the Republic or any other arrangement listed in the notice and in which the costs of such services exceed a certain monetary threshold will with effect from 3 February 2016 be a reportable arrangement.⁶⁵ The rationale for reporting an arrangement is that SARS will be notified of a transaction which it may consider to be suspect from a tax perspective which will enable SARS to investigate the transaction at an early stage.

3.5 Conclusion

It is submitted that current principles of taxation applied in South Africa fail to adequately address the unique features of e-commerce which may question the legal justification of the SA Revenue Services to claim taxing rights in this regard.

⁶⁴ Paragraphs 42.1 to 42.10 of the *Commentaries on the Articles of the OECD Model Tax Convention*, 2010 at 110.

⁶⁵ Government Notice No 140 of 3 February 2016, published in the Government Gazette No 39650, Public Notice in terms of sections 35(2) and 36(4) of the Tax Administration Act, 2011.

Chapter 4

Model Tax Conventions and International Tax Principles

It is understood that more than 3500 tax treaties are in place across the globe.¹

4.1 Introduction

As the globalisation of trade and the mobility of capital accelerated over the years, changes to the relationships between countries and the interaction of domestic tax systems became critical.

It is understood that the first treaty was signed in August 1843 between Belgium and France, but it was in the period that followed World War One that the risk of double taxation increased, due to growth in international trade.² The general concept of tax treaties in a multilateral situation, as it is known today, dates back to the work of a committee of economists in the early 1920's when a report was prepared containing the economic aspects of international double taxation and basic principles of conventions to avoid double taxation. It was the draft convention of 1927 that dealt with the concept of permanent establishment in order to acknowledge the taxing rights of contracting states.³ Following the first model Convention drafted in the late 1920's, the Fiscal Committee reported to the Council of the League of Nations on progress made in extending the network of Conventions⁴

¹ OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. <http://dx.doi.org/10.1787/9789264241046-en>.

² *International Tax, A South African Perspective*, 2011, Fifth Edition by L Olivier and M Honiball, Chapter 9, at 268.

³ *Transfer Pricing and the Arm's Length Principle in International Tax Law*, by Jens Wittendorff, Kluwer Law International, 2010, Chapter 3, at 87.

⁴ Fiscal Committee, Report to the Council on the Fifth Session of the Committee of the League of Nations, held at Geneva from June 12th to 17th, 1935, Official No.: C.252. M.124. 1935. II. A.

In order to further improve on the principles for the elimination of double tax, the Council of the Organisation for European and Economic Co-operation (OEEC) passed the first recommendation relating to double taxation on 25 February 1955.⁵

The efforts were updated over time to align with the changing economic environment which laid the foundation for the OECD Model Double Taxation Convention on Income and on Capital, published in 1977.⁶

4.2 Overview and purpose of the double tax treaties

A double taxation agreement is often also referred to as a 'DTA', a 'double tax treaty', a 'double tax convention', 'tax treaty', 'bilateral treaty' or simply a 'treaty' and these phrases are used inter-changeably in this study.

International trading has a risk of double taxation which may discourage cross-border trade and impact on economic relations between countries. Double taxation is referred to by the OECD as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods.⁷ Vogel describes it as a situation "...when two or more states impose taxes on the same taxpayer for the same subject matter."⁸

But tax treaties are not entered into merely to curb double taxation and according to Olivier and Honiball treaties also provide for the exchange of information and cooperation between contracting states as well as to rule out discrimination against non-nationals.⁹

The OECD Committee on Fiscal Affairs summarised the purposes of tax treaties as:

5 M Bennett, Head of Tax Treaty & Transfer Pricing Division, OECD Centre for Tax Policy & Administration, *The 50th Anniversary of the OECD Model Tax Convention*.

6 *ibi*.

7 OECD *Model Tax Treaty*.

8 *Double Tax Treaties and Their Interpretation* by Klaus Vogel, 4 Intl Tax & Business Law 1(1986), Introduction, at 4, available at: <http://scholarship.law.berkeley.edu/bjil/vol4/iss1/1>.

9 Olivier and Honiball, 5th Edition, at 276.

“The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement capital *and* persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion.”¹⁰

A tax treaty is commonly known as an agreement between the governments of two countries (bilateral) or in some instances between more than two countries (multilateral) with the primary objective, in a general context, to provide relief in situations where double taxation may occur. Olivier and Honiball explain that relief against double taxation is provided in that a treaty will state which of the two contracting states has the exclusive right to impose a tax on a particular type of income. In addition, the domestic law of a state may also provide for alternative relief methods also known as exemption or credit systems.¹¹ Under the exemption system the income is subject to tax in one state (referred to as the host state) and is exempt from tax in the other state (referred to as the home state) whereas under a credit system tax paid in one state (the host state) is used as a credit against a taxpayer’s liability in his home state. In South Africa relief is offered in terms of tax treaties by way of the credit method.¹²

Besides the relief for taxpayers, treaties also have the effect of allocating tax revenues between the Contracting States by stating which country will have taxing rights and under which circumstances.¹³ In addition treaties ideally also aim to prevent fiscal evasion and address double non-taxation.

It is of particular relevance for purposes of this study and more specifically in a South African context that one of the principles underlying a tax treaty between two contracting states is that profits of an enterprise of one of the states are taxable in that state unless that enterprise also conducts business in the other state through a permanent establishment (‘PE’) situated in that other state. This may be perceived as a prime example of a treaty allocating tax rights to a state, but it rather recognises

10 *Commentaries on the Articles of the Model Tax Convention*, (condensed version) – ISBN 978-92-64-08948-8 – © OECD 2010, Article 1, para 7, at 59.

11 L Olivier and M Honiball, *International Tax, a South African Perspective*, 2011, Fifth Edition, at 6.

12 *ibid* at 449.

13 *ibid* at 276.

that each contracting state applies its own domestic laws with the treaty merely limiting a country's application of domestic law in certain circumstances.

4.3 Tax Principles applied inconsistently

In general, countries tax both residents and non-residents on domestic source income.

4.3.1 Based on the principle of sovereignty referred to in paragraphs 2.3 and 2.4 above in determining the taxation of business profits in either the country-of-residence or the country-of-source, it may lead to conflicting results of where to tax the income.

“This dilemma has dominated international tax policy since the birth of the current system of international tax law at the beginning of the 20th century.”¹⁴

Furthermore, whilst the objective of tax treaties may be to provide guidance to contracting states, the Court acknowledged in *AB LLC and Another*,

“...the potential for the articles to be open to more than one interpretation is real, given that the interests of the various contracting countries are so diverse that it is impossible to cater for them all in one model treaty.”¹⁵

This study claims that the first key problem lies in the application of the legal doctrine that corporate entities should be treated like natural persons when testing for residency, which effectively force the concepts of residency and legal personality onto corporations.

Kahn, albeit in dealing with the elements of ‘domicile of choice of natural persons’, stated that ‘residence’ should be considered as a factual statement,

¹⁴ *Why Corporate Taxation Means Source Taxation, A Response to the OECD's Actions Against Base Erosion and Profit Shifting*, written by L U Cavelti, C Jaag and T F Rohner, (May 2, 2016). Available at SSRN: <http://ssrn.com/abstract=2773614> or <http://dx.doi.org/10.2139/ssrn.2773614>.

¹⁵ *AB LLC and BD Holdings LLC v The Commissioner of the South African Revenue Services*, 15 May 2015, Tax Court, Case No: 13276 at 12.

“It signifies habitual lawful physical presence...”¹⁶ So, the question is whether one should apply the same test(s) to corporate enterprises which may be incorporated in a country, but conducting business in another? It is an acceptable principle that a natural person cannot be present (physical presence) at two different locations at the same time, but that does not necessarily by implication mean that the same should apply to legal persons.

Cavelti *et al* argue that corporations should not be taxed in the country of residence as if they are individuals and should rather be taxed at source, that is to say, the place where these corporations conduct their business.¹⁷

Amidst this legal principle controversy several different tests are being applied by countries to determine the meaning of certain principles, for example the tax residence of non-individuals.¹⁸ Cavelti *et al* illustrate some of the inconsistencies, for example with ‘corporate residency’.¹⁹ The two major conventions relating to taxes on income and capital are the OECD Model Tax Convention and the United Nations Model Tax Convention and both provide for legal entities to be deemed resident and taxable in the country in which they are either registered, or have a place of management or any other similar measures.^{20,21} The effect thereof is that both conventions grant a level of discretion to countries to define corporate residency. Furthermore, Cavelti *et al* argue that without an internationally accepted and coherent interpretation of the concept of ‘source of income’, “...most countries allocate the source of income to the place of residence of the payer.” As both these conventions provide for tax to be paid in the country of residence and also in the country in which a corporation has a permanent establishment, it means that without a

16 *South African Law of Domicile of Natural Persons*, Ellison Kahn, Juta & Company Ltd, at 39 where the writer referred to Dicey & Morris 87; Wolf § 102 and JD McClean in (1962) 11 ICLQ 1157 – 60.

17 LU Cavelti, C Jaag and TF Rohner, *Why Corporate Taxation Means Source taxation, A response to the OECD's Actions Against Base Erosion and Profit Shifting*, 2016, Published by Social Science Research Network, May 2016.

18 *ibid*.

19 *ibid* Available at SSRN:<http://ssrn.com/abstract=2773614> or <http://dx.doi.org/10.2139/ssrn.2773614>.

20 *Model Tax Convention* (Condensed Version) © OECD 2014.

21 *United Nations Model Double Taxation Convention between Developed and Developing Countries*, published by the Department of Economic & Social Affairs, 2011.

permanent establishment, the country of residence may tax all the business profits, including that portion generated in the so called country of source.²²

The Commentary on Article 4 of the OECD MTC acknowledge that ‘resident’ could have several meanings in that one state may attach importance to the registration and other states to the place of effective management. Even with regard to the latter test some tax treaties refer to ‘place of management’ whilst others apply a test of ‘fiscal domicile of the operator’. The OECD has taken the view that “... the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made,” as the key determining factor.²³

Both these models assign an assumed or deemed status of residency on corporates. The OECD Model Convention in dealing with the concept of ‘Resident’ and more specifically with regards to corporations, states that “the term ‘resident of a Contracting State’ means an enterprise is deemed to be resident in the state in which it is liable to taxation as a result of **place of management** or any other criterion of similar nature.”²⁴ In that same article, it further qualifies ‘place of effective management’ of an enterprise as being a determining factor.²⁵

The UN Model has similar wording to the OECD Model in Article 4, but refers to both ‘**place of incorporation**’ and ‘**place of management**’ as being the criteria to define the resident status of a corporate enterprise.²⁶ (my emphasis)

Research has shown that a number of tests are being applied internationally and unilaterally under the domestic laws of different countries and this

22 LU Cavelti, C Jaag and TF Rohner, *Why Corporate Taxation Means Source taxation, A response to the OECD’s Actions Against Base Erosion and Profit Shifting*, 2016, Published by Social Science Research Network, May 2016 at 3 and 4.

23 OECD, *Commentaries On The Articles Of The Model Tax Convention*, (Condensed Version) – ISBN 978-92-64-08948-8 – © OECD 2010, Notes 23 and 24.

24 Article 4, paragraph 1 of the Model Tax Convention, OECD 2014.

25 Article 4, paragraph 3 of the Model Tax Convention, OECD 2014.

26 Article 4, paragraph 1 of the United Nations Model Double Taxation Convention between Developed and Developing Countries.

inconsistency not only creates uncertainty, but in my view often offers tax arbitrage opportunities which the authorities label as tax avoidance. The following examples, to list a few, illustrate the misalignment between states' interpretation of the principle of 'resident' and the tie-breaker rule,

- Incorporation or registration;
- Location of where senior management is centred;
- Centre of administration;
- Residency of the controlling shareholders;
- Place of main business activity; and
- Residency of the majority of directors.²⁷

It appears that in order to broaden the application of the test, the criteria allow a fair amount of discretion to countries in defining the resident status of a juristic person. Often the determination of how countries define the concept appears to be subjective and not creating clarity especially for multi-nationals. This apparent inconsistency, by assigning the concept of 'residency', as it would apply to individuals, on corporates, may have enabled multi-nationals shifting their profits to countries with either a low or no tax liability should the laws entitle them to do so.

The table below contains a comparative overview of a residence test for ten OECD Member countries applied to legal persons and illustrates the variation of criteria in claiming a right to tax.²⁸

²⁷ *The effectiveness of the 'place of effective management' tie-breaker rule in the OECD Model Tax Convention* by K Luker, Mini-dissertation, North-West University in quoting from Carroll C, 2002, *Corporate Residence, Taxation and E-commerce*, Irish Student Law Review, at 44.

²⁸ Australian Government, *The Treasury, International Comparison of Australia's Taxes* http://comparativetaxation.treasury.gov.au/content/report/html/12_Chapter_10-01.asp.



Country	Tax residence test — companies
Australia	<p>A company is an Australian resident if it is incorporated in Australia, or carries on business in Australia and has either its voting power controlled by resident shareholders or its central management and control in Australia.</p>
Canada	<p>A corporation is a Canadian resident if it is either managed and controlled, or incorporated, in Canada.</p>
Ireland	<p>A company is an Irish resident if it is managed and controlled in Ireland.</p> <p>All new companies incorporated in Ireland are regarded as resident for tax purposes, however this does not apply to a company if:</p> <ol style="list-style-type: none">1. it (or a related company) carries on a trading activity in Ireland, and:<ol style="list-style-type: none">i. it is under the control of person's resident in an EU member state or in a treaty country; orii. is (or is related to a company which is) quoted on an EU or treaty country stock market; or2. it is regarded under a tax treaty as being a resident in a treaty country and not resident in Ireland.



Japan	A company is a Japanese resident if it is incorporated, or has its head office, in Japan.
Netherlands	Company is treated as resident in the Netherlands if: <ol style="list-style-type: none">1. it is incorporated under Dutch law, generally as an NV (public limited) or BV (private limited) company; or2. it is actually situated in the Netherlands. A principal criterion is the location of the company's central management.
New Zealand	A company is a New Zealand resident if it is incorporated in New Zealand, it has its head office in New Zealand, its centre of management is in New Zealand or the directors (acting as directors) exercise control of the company in New Zealand. The head office of a company means the centre of its administration management.
Spain	A company is a Spanish resident if it is incorporated in Spain, has its registered office in Spain or has its place of management there.
Switzerland	A company is a Swiss resident if it is incorporated, or if its place of effective management is, in Switzerland.
United Kingdom	A company is a United Kingdom resident if its central management and control is in the United Kingdom, or it is incorporated in the United Kingdom.

United States	A company is a United States resident if it is incorporated under the laws of any State in the United States.
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It appears that most of the OECD-10 countries supplement their residence tests with substance-based tests.²⁹ The rationale is that without these tests entities may be able quite easily to reduce or avoid worldwide income taxation by migrating (in legal form) to a low-tax country without their underlying economic circumstances changing.

From the countries listed in the table above, it is noticeable that a number of tests or variable permutations of the same test are being applied to determine 'residency' for legal persons, which may give rise to dual residency or arbitrage opportunities. In Germany, the 'place of effective management' (where senior business management is centred) or 'registered office' of an entity are the determining factors to be considered.³⁰

A company will be deemed to be a resident in Canada if it has been incorporated in that country or managed and controlled. Some of the factors that Canadian courts have considered are:

- "the place where directors meet (this has been a particularly important factor);
- the principal place where business is conducted;
- the residency of the directors;
- the influence that foreign directors have in comparison with Canadian directors;
- the location of corporate books and records; and
- the location of the corporation's bank accounts."³¹

29 Australian Government, *The Treasury, International Comparison of Australia's Taxes* http://comparativetaxation.treasury.gov.au/content/report/html/12_Chapter_10-01.asp.

30 OECD, *Information on residency for tax purposes, Germany, Section II*, <http://www.oecd.org/tax/automatic-exchange/Germany>.

31 Article by Michael Wong on June 21, 2016, posted in Corporate Finance, Tax, <http://www.deallawwire.com/>.

In Australia, a company is a resident if it is 'incorporated in Australia' or if not incorporated in Australia such company 'carries on business' in Australia.³² The qualifying criteria for carrying on business in that country is that it either has its central management and control in Australia or the voting power is controlled by shareholders who are residents of Australia.

New Zealand considers a company to be resident if any of the following criteria apply:

- a) it is incorporated under the New Zealand Companies Act 1993; or
- b) control is exercised through decisions taken by directors in New Zealand; or
- c) the management of the company on a day-to-day basis takes place in New Zealand; or
- d) a company has its head office in New Zealand.³³

In the United Kingdom tax residence for a company incorporated outside the UK is determined if such company is 'centrally managed and controlled' from the UK. The emphasis is thus on control as opposed to where the main business is transacted.³⁴

In South Africa, a corporate entity will be considered resident as per the definition, and in essence the effective management of a legal person, that is to say, where key management and commercial decisions which are necessary for the conduct of the business as a whole are taken will constitute 'residence' in South Africa.³⁵ (see also 3.3.1 above).

4.3.2 Another challenge is that enterprises may avoid the status of 'permanent establishment' by applying the inconsistent and difference in interpretation of treaty rules under the domestic laws of states and the uncertainty surrounding

³² Australian Government, Taxation Office, *Residency requirements for companies, corporate limited partnerships and trusts*, <https://www.ato.gov.au/Business/International-tax-for-business>.

³³ The New Zealand Income Tax Act, No 97 of 2007 as amended.

³⁴ Halsbury's Laws of England, Fifth Edition, Volume 59, 2014, Lexis Nexis, para1779 at 45.

³⁵ The South African Income Tax Act, No 58 of 1962, Interpretation, Section 1, paragraph (b).

the treatment of the concept in the light of the digital economy. For as long as it is not clear what constitutes a permanent establishment, especially pertaining to e-commerce and there is no international law that governs the principle of what constitutes a permanent establishment or the OECD delay the implementation of clear and concise guidance, opportunities will, due to international uncertainty and misalignment of domestic rules between states, be applied to generate double non-taxation. The concern is that efforts at international level to align tax systems are now more at risk even after the publication of the OECD BEPS Reform Measures.

There is a risk that tax authorities may start taking unilateral action and implement their own initiatives in their pursuit of raising more tax revenues. The OECD in its Action Plan on BEPS acknowledged the risk of countries designing incoherent domestic tax rules creating gaps and frictions and henceforth the BEPS reform measures were aimed at addressing international standards in a co-ordinated and comprehensive manner. See also Chapter 7 which deals critically with the concept of permanent establishment in the digital economy.

4.4 Model Tax Conventions

A model tax convention is a standardised and comprehensive set of rules prepared by an organisation representing several member states that serves as guidance for drafting and negotiating tax treaties. In general, it contains the basic aspects, definitions, legal nature, purpose and interpretation of the principles and rights and obligations of contracting states.

In principle, three models for drafting double taxation agreements have been developed over time, although there are several more. For example, the Andean Community Income and Capital Model Tax Treaty, the Intra-ASEAN Model Double

Tax Convention on Income, and the draft SADC Model Tax Agreement on Income for Southern African countries.^{36,37}

The main models are the OECD model, the most commonly used framework, the treaty prepared by the United Nations which was published in 1980 and the US Model first published by the US Treasury Department in 1976, which serves as a guideline for US treaty negotiations. The majority of treaties today are based on the OECD Model Tax Convention on Income and on Capital (OECD Model) and the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model).

The OECD, has been widely acknowledged worldwide as an organisation setting the substantive international tax standards.

South Africa has its own model tax convention which is used as a basis when negotiating treaties.³⁸ The South African Model Agreement is an internal document of South African Revenue Services and as such, not available to the public. According to Krause this model is based on rules and terminology contained in the OECD MTC, the UN Model and the Southern African Development Community (SADC) Agreement for the Avoidance of Double Taxation and the prevention of Fiscal Evasion with respect to Taxes on Income.³⁹

³⁶ Andean Community Income and Capital Model Tax Treaty, 2004.

³⁷ Intra-ASEAN Model Double Tax Convention on Income, 1987.

³⁸ *International Tax, A South African Perspective*, L Olivier and M Honiball, Fifth Edition, at 272.

³⁹ *A comparative Study of Double Tax Agreements in a Southern African Context* by Frans Albert Krause, submitted in fulfilment of M. Com in Taxation, University of Pretoria, June 2015.

4.4.1 OECD

The Model Tax Convention on Income and Capital is published and updated by the OECD an international organisation with its objective to promote economic development and growth in its member states. The set of guidelines as it appears today was prepared by the developed countries of the world and contains rules adopted by primarily the capital export countries consisting of 35 member states.⁴⁰ The underlying emphasis is to benefit the residence state.

4.4.2 UN

The United Nations Model Taxation Convention has been drafted between developed and developing countries with a more biased objective to reflect the interest of the developing countries and benefit the source state. A lower barrier for creating a PE is another perceived difference to the OECD model and with fewer restrictions on the taxing rights of the source country for example the time threshold required to constitute a PE for purposes of business income of non-residents, makes it more favourable for capital import and developing countries.

The importance of the UN Model is on the increase amongst developing countries which are mostly non-OECD members.⁴¹

40 OECD, *List of OECD Member countries*, <http://www.oecd.org/about/membersandpartners/list-oecd-member-countries.htm>.

41 United Nations, *Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*, Edited by Alexander Trepelkov, Harry Tonino and Dominika Halka, 2013.

42 US Treasury Department, *Release of the 2016 US Model Treaty including new provisions to combat base erosion and profit shifting*, published by EY Global Tax Alert Library, http://www.ey.com/Publication/vwLUAssets/US_Treasury_Department_releases_2016_US_Model_Treaty.

4.4.3 US

The United States Model which provides for the guidelines and principles followed by the states with whom the USA has signed treaties with.⁴²

4.5 Interpreting Tax Treaties

A tax treaty is considered to have a dual nature in that it is initially an international agreement between two or more states and it thereafter becomes part of domestic law of each of the respective states that are parties to the treaty.

One must, therefore, distinguish between the interpretation of a treaty relating to a difference of view between the states which are parties to the treaty and the scenario where the interpretation relates to the application of a treaty rule or concept by a taxpayer, tax administration or court of a country which is a party to such treaty.

In the event of a difference of interpretation between contracting states of a treaty the rules of interpretation pertaining to public international law will apply as tax treaties are recognised as international agreements.⁴³ To the extent that it is also part of domestic law, will it be subject to the rules applicable to domestic legislation, to the extent that the domestic law interpretation is not in "...conflict with the international obligations of the state in question."⁴⁴

The Vienna Convention⁴⁵ defines a treaty as "an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation." The nature of International law is understood to be a set of rules and principles which govern not only the relationship between states, but also

43 Klaus Vogel, *Double Tax treaties and Their Interpretation*, Volume 4, International Tax & Business Law. 1 (1986), Published by Berkeley Law Scholarship Repository.

44 *ibid* at at 31.

45 Vienna Convention on the law of treaties (with annex), Concluded at Vienna on 23 May 1969.

bind the states and corporations of the respective states⁴⁶ Article 26 of the Vienna Convention provides that treaties are binding upon the parties who enter into them and must be performed by them in good faith.

The following articles deal with interpretation:

Article 31 General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) Any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty; and
 - (b) Any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
 - (a) Any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) Any subsequent practice in the application of the treaty which establishes the agreement between the parties regarding its interpretation; and

⁴⁶ L Olivier and M Honiball, *International Tax, A South African Perspective*, 2011, Fifth Edition at 302.

- (c) Any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties intended it be so.

Article 32 Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31 or to determine the meaning when the interpretation according to article 31:

- (a) Leaves the meaning ambiguous or obscure; or
- (b) Leads to a result which is manifestly absurd or unreasonable.”

Accordingly, articles 31 and 32 make it clear that a Court may also use extrinsic aids to interpret a tax treaty. It is submitted that these aids are to be found for example in the OECD Commentary

4.6 Conclusion

In general, and in most countries, the interpretation of tax treaties with regard to the application thereof are left to the domestic courts of law to use ordinary domestic rules of interpretation. Most treaties also contain a provision that any term not otherwise defined in the treaty itself needs to be interpreted in accordance with what the laws in force in the jurisdiction of that treaty state.⁴⁷

⁴⁷ Article 3(2) of the OECD MTC is an example of such rule which provides that the term should be interpreted according to the domestic law of the state which has the right to tax.

The Supreme Court of Appeal ruled in a matter concerning the correctness of granting a preservation order under a double taxation agreement between South Africa and Australia. In terms of the DTA, a protocol provides for reciprocal assistance between the States in the collection of taxes, securing preservation orders and exchange of information.⁴⁸ The SCA held that,

“...in construing the relevant provisions, consideration must be had to the rules applicable to the interpretation of treaties which are binding on South Africa and all States as rules of customary international law.”⁴⁹

The Court affirmed the rules of interpreting statutes and agreements contained in articles 31 and 32 of the Vienna Convention on the Law of Treaties, 1969.⁵⁰

When dealing with a tax treaty based on the OECD MTC, the starting point is paragraph (2) of article 3 which allows each of the contracting states to interpret such term(s) in accordance with the provisions of domestic law of that state. It means that one may rely on the meaning of a term(s) which is familiar to domestic law applicable in that country.

Article 32 of the Vienna Convention rules allow a court of law to use other material or secondary aids to interpret a double tax treaty and in practice these aids are *inter alia* to be found in the OECD Model Tax Convention article 3 which sets out the general definitions and principles as well as the notes in the OECD Commentary.^{51,52} As stated in 4.3 above, countries attach different meanings to certain principles, for example, the resident test. In addition, there is uncertainty surrounding the application of permanent establishment with regards to e-commerce. This means

48 *Krok v CSARS* (20230/2014 and 20232/2014) [2015] ZASCA 107

49 *ibid* at 17 with reference to *Fothergill v Monarch Airlines Ltd* [1981] AC 251 at 282 C-F; [1980] 2 All ER 696 (HL); *Ben Nevis Holdings Ltd and Metlika Trading Ltd v Commissioners for HM Revenue & Customs* [2013] EWCA Civ 578 paras 17 and 18.

50 *ibid* at 17.

51 OECD *Model Tax Convention with respect to Taxes on Income and on Capital*, 2014.

52 *Commentaries on the Articles of the Model Tax Convention, Model Tax Convention* (Condensed Version) – ISBN 978-92-64-08948-8 – © OECD 2010.

that a term or phrase in a tax treaty could have different meanings depending on which state's domestic law is being applied.

Considering the tax treaty definition of permanent establishment, the question is whether one should extend the definition to include for example a computer server and/or other electronic activity which may point to a digital presence. The OECD Commentary provides that a server will constitute a PE subject to certain conditions whilst a website could not constitute a PE. However, it appears that there is no general consensus as to how e-commerce should be treated with regards to PE.

A further question is whether domestic law may override the provisions of a tax treaty.

Olivier and Honiball raise the valid question as to whether tax treaties should be interpreted according to the domestic law interpretation with reference to tax statutes or interpreted "...according to the internationally accepted interpretation principles which are used for international agreements generally, and for tax treaties specifically."⁵³

With South Africa, not being a signatory to the Vienna Convention and not being a member of the OECD, Section 233 of the Constitution of the Republic of South Africa prescribes to a reasonable interpretation that is consistent with international law which by implication means sources such as the OECD Commentary may be consulted for interpretation purposes. So, the question is whether domestic law may override the provisions of a tax treaty. Do these *extrinsic aids* not carry too much weight in interpreting a phrase or term of a tax treaty in a South African context?

In *Secretary for Inland Revenue v Downing* and in *ITC 1503* the Courts accepted that the Commentary to the Model Tax Convention issued by the OECD may be

53 *International Tax, A South African Perspective*, 2011, Fifth Edition, L Olivier and M Honiball, Published by Siber Ink, at 298.

applied in interpreting tax treaties, despite South Africa not being a member state.

54,55

It was held in *ITC 1544* and provided for in the Constitution that provisions of a treaty will rank equally with and form part of South Africa's domestic law and in the event of a conflict, domestic law will prevail as decided by the Supreme Court of Appeal.^{56,57}

The Supreme Court of Appeal supported the decision in the *Downing* case with regards to the legal effect of a tax treaty and ruled that, "Once brought into operation a double tax agreement has the effect of law."⁵⁸

54 1975 (4) SA 518 (A).

55 53 SATC 342 at 348.

56 44 SATC 456 at 460 and *International Tax a South Africa Perspective*, by L Olivier and M Honiball, 5th Edition, at 316.

57 AM Moola Group Ltd v CSARS 65 SATC 414.

58 *Commissioner for the South African Revenue Service v Tradehold Ltd*, (132/11) [2012] ZASCA 61 (8 May 2012) at 9.

Chapter 5

BEPS, the biggest threat to Countries' Tax Base

5.1 Introduction

Cross-border e-commerce activities and the tax challenges that arise as a result thereof were first scrutinized by the OECD in 1997 during a discussion between business and governments where a paper presented clarified the technical aspects driving e-commerce.¹ Following the 'Dismantling the Barriers to Global Electronic Commerce' conference held in Turku, Finland in November 1997 the OECD convened the conference 'A Borderless World: Realising the Potential of Global Electronic Commerce' the following year. In a report presented at the Conference in Ottawa, e-commerce was recognised as one of the most promising economic developments offering opportunities, but also challenges in finding the balance between establishing the fiscal environment to stimulate e-commerce versus a fair and equitable taxation framework honouring a country's taxing rights.² The Tax Advisory Group was assembled which in later years created the platform for the use of traditional international tax principles in formulating new rules.

The issue then and still is today whether e-commerce causes such substantial revenue losses and tax avoidance to warrant traditional tax laws and principles, for example, PE and Double Tax treaties to be reformed and changed to provide for a new framework aligned with the digital marketplace.

In a report by the OECD in December 2000 the question was raised as to whether changes needed to be made to the definition of PE as it appeared in Article 5 of the OECD Model Tax Convention at the time or whether the PE concept should be abandoned.³ In order to address this, issue the Technical Advisory Group (TAG) on

¹ OECD *Electronic Commerce: The Challenges to Tax Authorities and Taxpayers, Discussion Paper* provided by RN Mattson, Chief Tax Officer, IBM Corporation US, November 1997.

² OECD *Electronic Commerce: Taxation Framework Conditions*, a report by the Committee on Fiscal Affairs, 8 October 1998.

³ Clarification on the Application of the PE definition in E-commerce: *Changes to the Commentary*, 22 December 2000.

Monitoring the Application of Existing Treaty norms for the Taxation of Business Profits in the context of Electronic Commerce was tasked to investigate and report on its findings.

It was in 2008 that member states of the UN adopted the Doha Declaration which called for action to ‘address the challenges of financing for development.’ This conference recognised that efforts need to be stepped up to vastly improve international tax matters, tax collections and curb tax evasion.

In what followed, the OECD proceeded with a tax reform process to try and achieve tax certainty which gained momentum with the cooperation of OECD member states, on-member countries and tax industry representatives.⁴ This, according to Cockfield, ‘earned’ the OECD the status of legitimacy as a world tax organisation. The effort of the Tax Advisory Groups (TAGs) enabled the OECD to take the initiative to engage in discussions with member and non-member countries.⁵ The result of interaction with these countries are today contained in the Commentary in the Model Tax Convention (MTC) which often serves as guidance to tax administrations and courts worldwide with the interpretation of tax treaties.

As alluded to in this report, the success of creating tax certainty depends largely on reaching common ground amongst nations. However, it appears that tax authorities tend to disagree on several issues and a lack of consensus threatens certainty which is a critical element of a sound tax dispensation.

Over the past almost twenty years BEPS and tax treaty management has become a top priority discussion point on the tax agenda of many countries. A big concern for tax regimes is that a substantial amount of profits generated from cross-border business activities do not get taxed anywhere.

⁴ *Taxblog, The Rise of the OECD as Informal; World Tax Organization: Through National Responses to E-commerce Tax Challenges* by Arthur J. Cockfield, 23 January 2014 <http://taxblog.com/ajcockfield> accessed 17 August 2016.

⁵ *ibid*, at 19.

“Base erosion and profit shifting is sapping our economies of the resources needed to jump-start growth, tackle the effects of the global economic crisis and create better opportunities for all,” said OECD Secretary-General Angel Gurría.⁶

The OECD was tasked by the Group of Twenty (G20) leaders in 2013 to identify the most relevant issues and to develop and draft a strategy with actions to curb the impact of BEPS.⁷ The primary focus of the OECD amongst a number of other issues was to find suitable criteria to address the principles of residence and source in an attempt to counter BEPS.

In July 2013, the OECD launched the BEPS Action Plan to identify those reform measures needed to stem the wave of multi-national enterprises exploiting tax arbitrage opportunities. Furthermore, the supporting objective with this ambitious plan was to restore confidence in the international tax system. Determined to find answers to the multitude of problems the G20 Leaders endorsed the Project in September of that year.

It took the OECD Committee on Fiscal Affairs just two years to publish the BEPS package of reform measures in October 2015 which was accepted at the G20 Leaders’ Summit in Antalya in November 2015 with a cautious but optimistic message of ‘more work has to be done’.

5.2 Root causes of BEPS

BEPS is short for Base Erosion and Profit Shifting, a project initiative of the OECD supported by the G20 leaders who believe that multi-national businesses are able to reduce their corporate tax liability by shifting profits to low or no-tax jurisdictions.

The global financial crisis in 2008 recorded the largest and most severe drop in global economic activity in modern times that resulted in an unprecedented collapse in world trade. Governments in most countries were confronted with soaring debt

⁶ A meeting held on 8 October 2015, by OECD and the G20 finance ministers in Lima Peru.

⁷ Two-part Report to *G20 Developing Working Group on the Impact of BEPS in Low Income Countries*, Part 1 July 2014.

trying to keep financial institutions afloat. This had left governments with unavoidable and tough choices on how best to balance taxation with spending.

It became clear that the need for reform to ensure that profits are taxed where economic activities take place was the predominant objective. A working group reported as early as 2011 on the low tax collection by Sub-Saharan African countries and other developing nations of less than seventeen per cent of GDP in tax revenues vs UN minimum goal of twenty per cent.

To add to the consequences of the final crisis, the OECD reported that:

” A number of indicators show that the tax practices of some multinational companies have become more aggressive over time, raising serious compliance and fairness issues. These issues were already flagged by tax commissioners at the 2006 meeting of the Forum on Tax Administration in Seoul and different instruments have been developed to better analyse and react to aggressive tax planning schemes which result in massive revenue losses.”⁸

Perhaps this situation was exacerbated by uncoordinated tax policies between tax regimes and “current international tax standards may not have kept pace with changes in global business practices” that offered incentives to shift business activities to low tax jurisdictions.⁹ The impact thereof is often a decline in revenue collection and damage to the credibility of a country’s tax system. The report states that business leaders often laid the blame on ‘governments being responsible for incoherent tax policies.

A reporting 2013 showed that there is no single rule or provision that is the root cause of BEPS but rather an interplay of gaps and mismatches in different international tax rules.¹⁰

8 OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, at 6 <http://dx.doi.org/10.1787/9789264192744-en>.

9 OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, at 7.

10 OECD, *Addressing Base Erosion and Profit Shifting*, 2013.

The OECD project has targeted tax planning by multi-national enterprises whereby organisational structures and business affairs can be arranged in such a way that it exploits gaps and mismatches in tax rules. This research discovered that mismatches often relate to the application of double tax treaties which may lead to double non-taxation. An example to illustrate this is where the residence state recognises the concept of a permanent establishment and exempts (or does not tax) income derived by a resident enterprise from a permanent establishment in another country (the source state). However, in turn, the source state may not recognise a permanent establishment and does not enforce source-based taxation, which (may) gives rise to double non-taxation, that is to say, no taxation in both the source and resident states.

A less favourable, but still beneficial scenario may be where the source country, being in this example, recognises a PE and enforce source-based taxation, but at a low tax rate for example Mauritius and Ireland. A report showed that there is no single rule or provision that is the root cause of BEPS, but rather an inter-play of gaps and mismatches in different international tax rules.¹¹

With the build-up of events over recent years, tax authorities were adamant to discover measures to close gaps and re-align mismatches in international tax rules and in 2013 the OECD formulated an 'Action Plan on BEPS' in which fifteen actions were identified.

Research has shown that enterprises conducting business across multiple countries can manipulate international taxation rules and create benefits, which according to the OECD, could include one or more of the following,

- Aggressive tax planning by MNEs;
- Lack of transparency and coordination between tax administrations;
- Disproportionate payments to foreign associated companies;
- Supply chain activities whereby payments for goods and services are structured to create tax benefits (transfer pricing);

¹¹ OECD, *Addressing Base Erosion and Profit Shifting*, 2013.

- Manipulation of tax incentives not realising the otherwise intended objectives;
- The use of tax losses and other structured techniques presented by treaty rules to reduce a tax burden; and
- The disability of some tax regimes to access information and often the lack of capacity and/or effective legislative measures to challenge profit shifting.¹²

BEPS is ultimately considered to be caused by the disparity that exists between the taxation rules of countries and *inter alia*, more specific to this study, the fact that principles have not kept pace with the emerging digital economy. It is worth mentioning that in most instances where multi-national enterprises are considered to engage in BEPS, these enterprises actually do comply with the legal requirements of the laws of the respective countries involved.¹³

From a South African tax perspective, it is not yet clear how the revenue authority will react to the reform measures announced by the OECD in 2015. At the time of finalising this report, the Davis Committee's Final Report on BEPS has not been published yet.

5.3 Treaty shopping and double non-taxation

Many years of uncoordinated international tax dispensation inadvertently created tax arbitrage opportunities which have been available for multi-national enterprises to structure their business affairs. In later years, these innovative re-structuring initiatives were labelled by tax regimes and the OECD as 'treaty shopping', a particular form of 'treaty abuse'. Treaty shopping is the practice by which enterprises search for countries with beneficial tax treaty provisions and then structure their business affairs to take advantage of favourable treaty provisions.¹⁴

¹² *ibid* and OECD/G20 *Final Reports on Base Erosion and Profit Shifting Project*, of 2015.

¹³ OECD, *Addressing Base Erosion and Profit Shifting*, published in February 2013, at 28.

¹⁴ L Olivier and M Honiball, *International Tax, A South African Perspective*, 2011, Fifth Edition at 550.

Olivier and Honiball describes treaty shopping as “the use of a DTA by a person who is not resident in either of the treaty countries, usually through the use of a **conduit entity** resident in one of the countries.”¹⁵

It can also be described as a practice whereby multi-national businesses take advantage of more favourable tax treaties available in certain jurisdictions because it is available.¹⁶ A business that resides in a home country that doesn't have a tax treaty with the source country from which it receives income can establish an operation in a second source country that does have a favourable tax treaty in order to minimize its tax liability with the home country. Most countries have established anti-treaty shopping laws in recent years to circumvent this practice.

It appears that double non-taxation may arise as a result of one or more of the following scenarios:

- The domestic laws of two countries may follow different basis of taxation, the one state may follow a source basis and the other a residence-based system;
- Both countries may impose tax on a residence basis, but have different definitions of the concept of resident;
- The source principle is applied by two countries, but with different rules;
- Subsidiary companies are set-up in countries with beneficial tax treaty provisions, making use of the ‘conduit principle’.

Olivier and Honiball describe the so-called abuse of tax treaties or ‘treaty shopping’ as a deliberate establishment of a presence in a country to only make use of the benefits offered by treaty provisions.¹⁷ This is often also referred to as making use of a ‘conduit arrangement’ whereby business profits are passed through certain jurisdictions to obtain tax benefits.

The following example illustrates how the conduit principle may be used:

¹⁵ *International Tax, A South African Perspective*, Fifth Edition, 2011 by L Olivier and M Honiball, Glossary of South African International Tax Terms at 851.

¹⁶ OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, Action 6 - 2015 Final Report.

¹⁷ *International Tax, A South African Perspective* by L Olivier and M Honiball, 5th Edition, 2011, at 550.

Business A is registered and resides in Country 1 but also conducts business in Country 2 where it generates business profits, but pays tax at a reduced rate. In this instance let's assume that Country 1 has a residence-based system and that there is no double tax treaty between Country 1 and Country 2. That would mean that Business A will be taxed in Country 1, based on the residency principle and also in Country 2 (albeit at a reduced rate) on the source-based principle. This demonstrates the purpose of double tax treaties which is to avoid double taxation.

Since Business A cannot afford nor is it equitable to pay double tax on the same business profits, it decides to establish and operate through a subsidiary in Country 3 with whom Country 1 has a double tax treaty. Country 3 follows a territorial tax system (for example, Hong Kong, Malaysia and Singapore) which does not tax foreign income and only impose taxes on income earned in that country. The business profits generated in Country 2 will be subject to tax (albeit at a reduced rate) and when directed to Country 3 from where it is remitted to Country 1 by way of dividends it may not be taxable in Country 1. This entity in Country 3 serves as a conduit whereby business profits are routed through this jurisdiction which may not only avoid double taxation but also enjoying the benefits of a double tax treaty.

This appears to be legitimate and bona fide structuring, however, the question is, if Business A established the entity in Country 3 with the main or sole intention to benefit from double taxation treaties, will it be called 'treaty shopping'?

The OECD Commentary refers to treaty 'abuse' as the case where the actions of an enterprise are carried out essentially to obtain treaty benefits and raises the question¹⁸ as to whether the enterprise should be allowed to benefit from the treaty benefits or not? The answer to that question is contained in the Final Report of the Action Plan on BEPS, Action 6, which made recommendations (new treaty anti-abuse rules) to ensure that enterprises may only claim tax treaty benefits from those countries in which they have business activities that demonstrate a significant economic *nexus*.

18 OECD Commentaries on the Articles of the Model Tax Convention, Commentary on Article 1, 2010, paragraph 9.1.

The objective with Action six was to prevent treaty abuse by developing “model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances.” The final report introduced new treaty anti-abuse rules and with the aim to eliminate double non-taxation.¹⁹

In response to a review of the treaty practices, the OECD recommended three principal methods to curb treaty shopping:

- Firstly, to insert a clear statement in the preamble of double tax treaties endorsing the objectives of treaty partners which are to prevent tax avoidance.
- Secondly, and perhaps the principal purpose, to introduce a Limitation on Benefits rule (LOB) which is a specific anti-abuse rule similar to provisions found in treaties entered into by the United States, Japan and India. In terms, thereof and bear in mind that this proposal is still under review and that the final version will only be released in 2016, a Contracting State may deny treaty benefits if it is determined on a ‘substance over form’ test that the primary purpose of the planning was merely to obtain a treaty benefit. A further test is that only taxpayers who are ‘qualified persons’ (as defined), that is to say, rightfully ‘residents’ of the Contracting state from which they claim relief, may be entitled to these benefits.
- Thirdly, a general anti-abuse rule is recommended in the form of a “principle purpose test” which will ensure that relief is granted for the bona fide exchange of goods and services in line with the purpose for which treaties are entered into.²⁰

19 OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, Action 6 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

<http://dx.doi.org/10.1787/9789264241695-en>

20 OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, Action 6 - 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris.

<http://dx.doi.org/10.1787/9789264241695-en> at 18 ,56, 91,

5.4 Conclusion

The OECD countries, working together with the EU, developing countries and several other tax organisations to revise the fundamentals of the international tax rules, concluded that the digital economy actually exacerbated BEPS issues.²¹ The view is that multi-nationals can effectively establish structures that separate business profits from the value-added activities of their businesses. Action 1 of the BEPS Project dealing with the digital economy, examined "...the ability of a company to have a significant digital presence in the economy of another country without being liable to taxation due to the lack of *nexus* under current international rules..."²²

In order to counter these practices, the BEPS Project set itself the target to ultimately ensure that profits are reported where the economic activities that generate them are carried out and where value is created, that is restoring source taxation.²³ The Project also acknowledged that the digital economy brings much wider challenges which include the allocation of taxing rights amongst countries. This issue is dealt with in Chapter Six below.

21 OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1*, 2015 Final Report

22 *ibid* at 16.

23 *ibid* at 87, 146.

Chapter 6

Dynamics of the digital economy and challenges to taxation

6.1 Introduction

Although globalisation has had a positive effect on the development of tax systems, it has also had a negative impact in that it has created opportunities for taxpayers to minimise or even avoid tax liabilities thereby eroding the domestic tax base of many countries. This has created fierce competition amongst tax systems and resulted in countries being forced to modify and protect their tax bases. The threats of potentially harmful tax competition called on the OECD to compile a report addressing the need to “develop measures to counter the distorting effects of harmful tax competition on investment and financing decisions and the consequences for national tax bases ...”¹

The Technical Advisory Group (TAG) submitted its Final Report in June 2004 addressing the question as to whether the current treaty rules for taxing business profits are still appropriate for e-commerce and concluded that e-commerce does not require nor justify radical changes from (the then) current rules.² The OECD admitted in the Final Report on BEPS that e-commerce poses challenges to international taxation and policymakers, but expressed its confidence that measures will adequately address the matter. In the words of the Secretary-General of the OECD:³

“The measures we are presenting today represent the most fundamental changes to international tax rules in almost a century: they will put an end to double non-taxation,

¹ *Harmful Tax Competition, An Emerging Global Issue Report* by the OECD approved on 9 April 1998, Foreword at 3.

² OECD *Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits, Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce*, Final Report, June 2004, Conclusion paragraph 350, at 72.

³ OECD, *Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project.

facilitate a better alignment of taxation with economic activity and value creation, and when fully implemented, these measures will render BEPS-inspired tax planning ineffective.”⁴

However, according to many commentators, including Avi-Yonah and Xu the measures are considered inadequate and fall far short in tackling BEPS in the digital economy. These writers expressed a strong view that Secretary-General Angel Gurría’s optimism is not justified whilst some of the most difficult questions have remained unanswered with further work to continue and more guidelines to come in 2020 covering the overall taxation of the digital economy.⁵

So, the question remains whether one can gain any certainty from the OECD’s guidelines and to what extent multi-national businesses can plan and act with confidence while so many areas remain unresolved.

6.2 Features of e-commerce

Although there are several definitions for e-commerce, it means in short “any commercial transaction conducted wholly or partly by using the Internet”⁶

E-commerce has also been described as the delivery of goods or services which does not require a physical exchange or interaction with customers and the concept was defined in *Cyberlaw @SA III* as “...the buying and selling of products or services over electronic systems such as the internet and other computer networks.”^{7,8}

4 OECD, Centre for Tax Policy and Administration, OECD presents outputs of OECD.G20 BEPS Project for discussion at G20 Finance Ministers meeting, October 5, 2015.

5 New York University School of Law Colloquium on Tax Policy and Public Finance, Evaluating BEPS, Spring 2016 23 Feb 2016.

6 *The Political Feasibility of a Global E-Commerce Tax* by Rifat Azam, Radzyner School of Law, Interdisciplinary Center, Herzliya and published by the University of Memphis Law Review, Volume 43, at 7.

7 *Why Corporate Taxation means Source Taxation, A Response to the OECD’s Actions Against Base Erosion and Profit Shifting* by L U Cavelti, C Jaag and T F Rohner, 7 December 2015, at para 3, subpara 3.3.1 at 11 paper published by Social Science Research Network on 2 May 2016.

8 *Cyberlaw @ SA III, The Law of the internet in South Africa*, Third Edition, edited by S Papadopolous & S Snail, published by Van Schaik, Chapter 3 by Carmen Cupido, Subpara 3.1.1, at 25.

An example to illustrate the complexities that tax authorities are faced with today in determining taxing rights appeared from an article written by DM Davis and quoted by Cyberlaw.^{9,10} In order for an e-commerce transaction to be concluded and executed it could involve multiple elements spread across several countries to make up a complete and integrated process, for example a French supplier of food and wine was used to illustrate the difficulties. Assume for purposes of this example that the business' website is hosted in the US and this website enables the business to trade world-wide. Although the business is managed in France, the import and export activities are conducted in Hong Kong where the website was designed and from where products are dispatched to consumers internationally. Based on this example, the question is **which country may claim taxing rights for corporate tax on the business profits of the supplier company**, derived on my order, delivered and consumed in South Africa? (my emphasis)

Buyts & Cronje alluded to the challenges that face international tax law which are, to name a few:

- digital trade does not require a location (residency or a permanent establishment) in a particular jurisdiction and often takes place in cyberspace;
- the identity of potential taxpayers and data of the nature of goods and services traded (intangible digital products which include, music, software, videos and electronic books) are mostly unknown to tax authorities; and
- the incapacity of authorities to administer tax compliance; and
- the uncertain extent in monetary value of business profits generated from cross-border trade.¹¹

An article in response to the OECD's actions against BEPS referred to the example of a university offering programs to students throughout the world without necessarily

⁹ *Residence based taxation: is it up to the e-commerce challenge?* Acta Juridica 2002, at 162.

¹⁰ *ibid*, Chapter 6, *Income Tax and e-commerce* by Liezel Classen, at 96.

¹¹ *Cyberlaw @SA II, The Law of the internet in South Africa* by R Buyts & E Cronje (Editors), 2nd Edition, 2004, published by Van Schaik, at 314.

having a presence in the country of its students.¹² This one example of which there are many, illustrates that digital technology challenges the traditional concept of permanent establishment and other conventional tax principles.

In order to further emphasise the challenge of policymakers, one has to also take account of the following unique features of e-commerce:

- It is virtual in the sense that it is determined by Internet;
- It ignores territorial or geographic borders;
- It has no geographic location and takes place on a global basis;
- An element of anonymity exists, that is to say, parties and the details of e-commerce transactions, are mostly not known or easily detected;
- Transactions take place in a virtual space, that is to say, it has no physical existence or place outside the Internet.

Today, technological innovation and development has a direct impact on the way in which multi-national enterprises are managed and made the physical location of management and activities much less important. According to Cyberlaw, it is the very nature of products that may be traded over the Internet, consisting of a network of complex electronic systems, which may even take place in cyberspace, which makes it practically difficult to assign a given location for purposes of jurisdictional tax principles.¹³ ‘Cyberspace’ is referred to as a notional environment “...where computer communications and simulations are used on the internet” and according to Cyberlaw with the challenge that “jurisdictions often intercept and collide.”^{14,15}

¹² *Why Corporate Tax Means Source Taxation*, an article by LU Cavelti, C Jaag and TF Rohner, 24 April 2016, at 11.

¹³ *Cyberlaw @ SA III, the law of the internet in South Africa*, Edited by S Papadopolous and S Snail, Van Schaik Publishers, at 103.

¹⁴ The Law Dictionary Featuring Black's Law Dictionary Free Online Legal Dictionary 2nd Ed.

¹⁵ *ibid*, at 288.

According to Verwey it is almost impossible to tie the Internet and henceforth e-commerce conducted via Internet to a ‘traditional fiscal jurisdiction’.¹⁶ The reason for this is that e-commerce is enabled through the integration of the physical component (hardware) and information component (data/software) and none of these components are necessarily bound to a specific territory and place. Following a strict and conventional approach, e-commerce largely discredits well-established tax principles as the Internet is not bound by geographic boundaries or space nor can one enforce ‘residency’ on it.

Considering the features of e-commerce, my view is that this dynamic growing part of any country’s economy poses a major and real challenge to international taxation and traditional principles which still today and even after the recent OECD guidelines, are state-based with a primary focus on territorial jurisdiction and physical presence. So, the relevant question for purposes of this report is whether e-commerce can constitute a permanent establishment as provided for in Article 5 of the OECD Model Tax Treaty?

6.3 OECD on e-commerce

The OECD defines e-commerce as follows:

“An e-commerce transaction is the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or services do not have to be conducted online.”¹⁷

Before the turn of the century tax observers raised concern that the traditional tax principles no longer provided for the new commercial environment and several so-called e-commerce reform efforts were started.

¹⁶ *The Principles of Source and Residence Taxation of Electronic Commerce Transactions in South Africa*, Mini-dissertation by PM Verwey, 2007, at 4 and with reference to D du Plessis “Taxation of E-commerce in Buys R (ed), *Cyberlaw@SA II: The Law of the Internet in South Africa*, Second edition, Van Schaik Publishers, 2004, at 297.

¹⁷ OECD *Guide to Measuring the Information Society*, 2011 and last updated on 17 January 2013, Glossary of Statistical Terms, Hyperlink: <http://browse.oecdbookshop.org/oecd/pdfs/free/9311021e.pdf>.

The OECD Committee on Fiscal Affairs concluded in 1998 “...that the principles which underlie the international norms that it has developed in the area of tax treaties and transfer pricing (through the Model Tax Convention and the Transfer Pricing Guidelines) are capable of being applied to electronic commerce...”¹⁸

Challenges associated with e-commerce, however, remained a relevant issue and prompted the OECD Committee on Fiscal affairs in January 1999 to establish the Technical Advisory Group (TAG) to “examine how the current rules for the taxation of business profits apply in the context of electronic commerce”.

This was seen by the international tax community as an important step towards developing consensus on international tax principles. A number of technical advisory groups were set up to investigate and submit proposed changes of how to combat the emerging challenges of e-commerce. The following were some of the proposals:

6.3.1 The unique features of e-commerce make it difficult to characterise the nature of income derived from these business activities. The Commentary now makes it clear that income derived from the sale of digital products is to be treated the same as software payments, that is to say, to be taxed as business profits. However, the effects of the digital economy still create problems with characterising the nature of certain sources of income, for example, internet platforms collecting network rental, advertising revenues or revenues generated through data collection;

6.3.2 A server will constitute a permanent establishment if:

- The server performs an integral part of a cross-border transaction;
- The server is either owned or leased by the non-resident business; and
- The server is fixed at a location in the host country for a considerable period of time.

A website is considered not to constitute a permanent establishment.

18 OECD Report by the Committee on Fiscal Affairs on Electronic Commerce: *Taxation Framework Conditions*, 8 October 1998, para 11, Box 3, element (ix).

6.3.3 With regards to ‘resident’, changes were proposed which should apply as a tie-breaker test in the event that the place of effective management cannot be determined with certainty. The following tests are to be applied on a cascading or waterfall basis:

- “...whether the current rules to determine *nexus* with a jurisdiction for tax purposes are appropriate”;
- “...how to attribute value created from the generation of data through digital products and services...”; and
- Digital products and services “...creates uncertainties in relation to the proper characterisation of payments made in the context of new business models,...”¹⁹

With regards to the nature of payments derived in terms thereof, this study questions whether these payments may be deemed to be akin to royalties (for example, e-books, music or software downloaded), fees for services (hotel and flight bookings online), business profits (Amazon products sold online) or rentals (videos and movies, for example, Netflix).

6.3.4 The Commentary to the OECD MTC was amended with regard to cross-border services to provide for a permanent establishment in the event of consulting or other similar services where the foreign enterprise or its employees use a client’s premises for an ‘extended period of time’.

The loss of tax revenue caused *inter alia* through the unique features of the digital economy prompted the OECD to take further action and at a meeting of the G20 leaders in 2013 the OECD BEPS Action plan was launched.²⁰ Having acknowledged that the growth of e-commerce has its own unique characteristics, Action 1 was set to examine those difficulties which the digital economy poses when applying existing international tax rules. Of particular

19 OECD (2015), *Addressing the Tax Challenges of the Digital Economy*, Action 1 – 2015 Final Report, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris at 99

20 OECD (2013) *Action Plan on Base Erosion and Profit Shifting*, July 2013.

concern was the ability of an enterprise to have an active digital presence in a country without paying tax in that country.

Insofar as direct taxation is concerned, the following main policy challenges were raised:

- Whether the current rules to determine *nexus* with a jurisdiction for tax purposes are appropriate;
- How to attribute value created from the generation of data through digital products and services; and
- Digital products and services create uncertainty with regards to the nature of payments derived in terms thereof, that is to say, are these payments akin to royalties (for example, e-books, music or software downloaded), fees for services (hotel and flight bookings online), business profits (Amazon products sold online) or rentals (videos and movies, for example, Netflix).

For purposes of this study it is important to note that the findings and recommendations contained in the Final OECD Report on Action 1 relating to the digital economy also have strong links with the scope of Action 7 concerning the concept of permanent establishment. Although the findings in Action 7 relate primarily to the prevention of artificial avoidance of PE status, the view is held that the inherent nature of e-commerce enables a business enterprise to have a digital presence in another country without having a permanent establishment in that country and, hence, no *nexus* exists for that country to claim taxing rights. It has become possible through progressive digitalisation processes to move many business functions to distant locations benefiting from lower taxes. From there a cross-border e-commerce business can be conducted including the delivery of goods and services in digital form or otherwise through new channels.

The draft report of 2014 acknowledged that the nature of digital transactions gave rise to severe administrative challenges, first of all, the difficulty in identifying such business enterprises and then locating them, secondly to determine the extent of activities and finally the collection of information and verification thereof.

Based on the framework set for Action 1 in 2014 and the final report in 2015, the OECD explored the following important measures:

- Whether the list of exceptions to Article 5, especially regarding auxiliary and preparatory activities, needs to be amended;
- The possible introduction of a digital permanent establishment to serve as a nexus for the digital economy;
- Alternatively, whether to replace the traditional PE concept with a significant presence test; and
- New forms of source taxes.
- The OECD finally acknowledged the following key characteristics which form part of the digital economy: Mobility in the context of the digital economy must be understood in broad terms. This relates to the flexibility and freedom, if one wants to work, shop and engage with others anywhere (from one side of the globe to the other side) and anytime (24 hours a day). It also refers to the intangibles which form an integral part of the digital economy and a reduced need for people to perform certain functions;²¹
- It relies on the collection, storage and transmission of data which in a South African context is defined in the Electronic Communications and Transactions Act 25 of 2002 as, “electronic representations of information in any form.”;
- Users participate and integrate with networks which are spread throughout the world;
- The interaction can be by way of multi-sided (where web-based platforms connect different players, for example, users and advertisers with pricing methodologies on different sides of the platform that are interdependent) or based on single-sided business models enabling virtual interaction and the creation of value from different jurisdictions; and

²¹ OECD, Final Report, *Addressing the Tax Challenges of the Digital Economy*, 2015, at 64.

- E-commerce is also known for its volatility caused by fairly low barriers of entry allowing businesses of all market segments to participate as well as rapid evolving technology which gives rise to an element of unpredictability

The BEPS Project identified a number of technical options to consider in dealing with challenges raised by the digital economy, but none of the options were adopted. It was proposed to rather monitor developments in this regard and take the necessary decisions over time. The following three tax change options relating to the sale of digital goods and services by foreign suppliers without a PE were analysed:

- Corporate Income Tax to be levied on net income attributable to economic activity;
- A form of excise tax which is similar to a final tax on consumption; and
- A withholding tax that could be collected from financial intermediaries that process payment for foreign purchases.²²

The Report concluded that it believes that some of the changes announced will be sufficient to mitigate direct tax challenges and that it was decided not to adopt any of the abovementioned options. It was decided that three focus areas will be monitored going forward which are:

- Developments in Information and Communications Technology (ICT) and how that may impact international tax;
- To what extent the announced BEPS measures will impact tax challenges; and
- To take into account the effect of these changes implemented by countries in their respective domestic legislation.

²² OECD/G20 Base Erosion and Profit Shifting Project, *Addressing the Tax Challenges of the Digital Economy*, Action 1: Final Report @ 148 and Annex E, at 276.

Countries were invited to introduce any of the options in their own domestic laws to combat BEPS.

The conclusion reached by the task team in its final report on the digital economy was that work will continue towards 2020 on some of the most difficult tax questions.

Taking into account the challenges of the BEPS project and what was achieved through the project, the view is that it will remain difficult to determine where data is collected, stored and used, that is to say, where it creates value – and to where taxation should apply.

This study maintains that tax authorities and policy makers will have to test these difficulties and any proposed changes against the fundamental principles of an effective tax system (see Chapter Two above).

The question remains for purposes of this study and based on the OECD findings to date, whether a foreign business enterprise transacting with consumers in South Africa via the Internet, will constitute a permanent establishment in South Africa?

6.4 EU policy recommendations on the digital economy

The EU defines the digital economy (as quoted from a United Nations paper which in turn copied it from an Australian Government Report) as, “the global network of economic and social activities that are enabled by platforms such as the Internet, mobile and sensor networks.”²³

A study paper prepared by the European Union expressed doubts as to whether the OECD/G20 BEPS recommendations, especially with regards to the digital economy,

23 European Parliament, Directorate General for Internal Policy, Study on Tax Challenges in the Digital Economy, June 2016, at 13 quoted from United Nations Department of Economic and Social Affairs (2014), Protecting the Tax Base in the Digital Economy, at 5 copied from Department of Broadband, Communications and the Digital Economy, Australian Government. What is the digital economy? [Online] Available from: http://www.dbcde.gov.au/digital_economy/what_is_the_digital_economy [Accessed 16 September 2016].

will have the desired effect of addressing the real issues.²⁴ These measures are viewed by the European Commission to be “impractical, irrational or temporary in nature” and “fail to address the core of the problem.”

This, according to this study, is due to the inherent characteristics of e-commerce being, ‘anonymity, difficulty to determine the amount of tax, lack of paper trail, tax havens, companies incurring liability in multiple jurisdictions and tax administrations’ lack of capacity to manage tax’.

In summary, a physical presence or *nexus* is no longer required for a business to have access to customers. The OECD, however, failed in its Final Report in 2015 to establish a ‘significant digital presence’ test which formed part of the Discussion Draft in 2014.

Referring to the work that has to be done by the OECD over the next five years as part of the ‘Beyond BEPS’ strategy, the EU prefers a more urgent response and action. The EU highlighted taxable *nexus* provisions as one of the priority areas that will receive attention, but agreed that no immediate special action is needed for the digital economy. It was decided that as an organisation it will monitor the results of the general anti-avoidance measures proposed by the OECD and noted with interest and undertook to examine the withholding tax on digital transactions and equalisation levy adopted by India.

6.5 Davis Tax Committee on the digital economy

The Davis Committee noted in its interim report (the final report has not been published at the time of finalising this report) that case law and principles applied in South Africa with regards to source of income do not cover the intricacies of the

²⁴ European Parliament, Tax Challenges in the Digital Economy, prepared by the Policy Department A: Economic and Scientific Policy, June 2016.

digital economy and that at the same time tax legislation does not adequately provide for e-commerce either.²⁵

The Committee made the following statements on direct taxes for the digital economy:

- Guidance should be taken from the OECD in order to adopt a feasible solution aligned to rapid changing technology;
- It may be appropriate to consider new source rules in order to tax non-residents where the consumption takes place in relation to e-commerce;
- New rules should also characterise the nature of income generated through digital transactions;
- It may be appropriate to consider new source rules in order to tax non-residents where the consumption takes place in relation to e-commerce;
- In formulating new rules, it is important that only that portion of income that can be attributed to the digital activities in South Africa should be accounted for;
- Without being able to identify an enterprise having a permanent establishment in South Africa a major administrative and compliance burden will be posed. The lack of available data makes it difficult to ascertain the extent of inbound and outbound flows relating to e-commerce.
- Ideally, rules should enforce non-resident enterprises to submit income tax returns even if they not have a permanent establishment in South Africa.
- Source rules should be aligned with accounting principles and incorporated in a newly designed income tax return (IT 14) to allow for disclosure of inbound investment flows and factual accounting questions.

²⁵ *Addressing Base Erosion and Profit Shifting in South Africa, Action 1: Address the Tax Challenges of the Digital Economy*, Interim Report, 23 December 2014 - Media Statement - Release of First Interim Report on BEPS for public comment by 31 March 2015.

- The Electronic and Transactions Act need to provide for means to detect and identify enterprises involved in e-commerce.
- Policy changes need to ensure a fair and equitable dispensation of taxing business profits although to get international consensus may prove to be difficult.
- Exchange of tax related information between countries will play a much bigger role in future.

In support of such a move, South Africa recently signed the OECD Mutual Administrative Assistance in Tax Matters Convention.

At the time of completing this report it was uncertain as to what recommendations the Davis Tax Committee will submit in this regard.

6.6 Conclusion

In a presentation by IBM the unique aspects listed below, should be a cause for concern for tax administrators considering the characteristics of the digital economy and illustrates the far-reaching consequences it may have in applying traditional tax principles, for example 'permanent establishment', 'source' and 'resident'.

- "World's largest taxi company owns no taxis (Uber)
- Largest accommodation provider owns no real estate (Airbnb)
- Largest phone companies own no telco infra (Skype, WeChat)
- World's most valuable retailer has no inventory (Alibaba)
- Most popular media owner creates no content (Facebook)
- Fastest growing banks have no actual money (SocietyOne)
- World's largest movie house owns no cinemas (Netflix)

- Largest software vendors don't write the apps (Apple & Google)"²⁶

The peculiar features of many multi-national enterprises, today, demonstrate in my view that it is no longer unusual for business to have a virtual and no physical presence in several countries.

This study concludes that the emergence of the digital economy has affected the ability of taxing authorities to impose and collect tax on e-commerce transactions and corporate profits generated in a virtual and growing market.

The EU share the view of the OECD that the challenges posed by the digital economy lie in the difficulty to define tax jurisdiction without the need for a physical or legal presence and as a consequence, avoiding the PE status requirement. Commentators explain that governments are challenged more and more by multi-nationals with organisational structures that result in zero-tax and stateless income.

My view is that the rules have not kept up to date with technology and the developments giving rise to the growing digital economy and that even after the OECD's final report on international tax reforms published in 2015, the principle of taxing rights or the appropriate place to tax business profits with regards to e-commerce, remains a controversial subject.

²⁶ Presentation made by Sandy Carter, IBM for Entrepreneurs event, The Digital Disruption Has Already Happened, reported by John Kennedy, *How digital disruption changed 8 industries forever*, 25 November 2015 and accessed on <https://www.siliconrepublic.com/companies/digital-disruption-changed-8-industries-forever>.

Chapter 7

Research Conclusion

7.1 Introduction

The concept of ‘permanent establishment’ (PE) is well entrenched in tax treaties and has become an accepted international tax principle and key legal concept, applied to ensure that double taxation is avoided. Although tax treaties do not create taxing rights, Olivier and Honiball state that articles 5 and 7 of the OECD MTC are the best-known exception to this rule.¹

Article 7 in essence assigns taxing rights with regards to business profits generated through a PE to one of the countries under a tax treaty. The basic idea with the principle according to Cockfield is that countries agree when concluding a tax treaty that they respectively will not impose tax on the business profits of a non-resident unless the profits relate to a business carried on through a fixed place of business within the borders of a country.²

Such an agreement between two or more countries supports the sovereignty principle whereby a country may tax foreign enterprises as long as they have income generated within such country’s jurisdiction. In return, the country where such entity is resident agrees to offer tax relief for the taxes paid in the host country where such permanent establishment was created. The underlying and implied meaning of the concept is, therefore, that it actually defines the source which generates the income, that is to say, from where payment is made. Whilst the United States have codified special rules for determining source and other general rules relating to foreign income, most other

¹ *International Tax, A south African Perspective* by L Olivier and M Honiball, 2011, Fifth Edition, at 18.

² Arthur J Cockfield, *Reforming the Permanent Establishment Principle through a Quantitative Economic Presence Test*, 2003, 38 *Canadian Business Law Journal*, at 400 – 422.

countries have different rules and the OECD's Glossary of Tax Terms contain the following explanations:

- “SOURCE OF INCOME -- The place (or country) where a particular item of income is deemed to originate or where it is deemed to be generated. National rules vary, depending on which concept of source is used.
- SOURCE PRINCIPLE OF TAXATION -- Principle for the taxation of international income flows according to which a country considers as taxable income those income arising within its jurisdiction regardless of the residence of the taxpayer, i.e. residents and non-residents are taxed on income derived from the country.
- SOURCE RULE - Provision in the national law of a country or in a tax treaty which defined the concept of source for a particular type of income.”³

It is, however, relevant to note that ‘source’ in this instance is used in a very wide sense, meaning the place from where payment is made by the payer or where the income is earned. Used in this context it means the place where the payer resides and should not be confused with the ‘source’ principle established in South Africa and generally accepted as meaning the ‘originating cause’.

So, the question arises as to what needs to occur in order to constitute a permanent establishment?

A closer look at the general definition in OECD MTC, Article 5 paragraph 1 and the Commentary on this article reveals the following requirements that are needed to constitute a permanent establishment:

7.1.1 There must be an ‘**enterprise**’ (in terms of the general definitions in Article 3 of the Model Tax Convention, the word ‘enterprise’ applies to the carrying on of any business, which implies that there must be a ‘business’.) The term ‘business’ in turn, is defined to include “*the performance of professional*

³ OECD, *Centre for Tax Policy and administration, Glossary of Tax Terms* accessed through www.oecd.org/ctp/glossaryoftaxterms.

*services and of other activities of an independent character.*⁴ It follows that the term ‘business’, used in this context should be given its ordinary meaning and interpreted according to the provisions of the domestic laws of the Contracting States in what is understood as a business, for example, a commercial activity or trade;

7.1.2 The existence of a ‘**place of business**’, a location such as a facility, that is to say, a certain amount of space at its disposal, premises or equipment, including a place of management, branch, an office, a factory, a workshop, and a mine, oil or gas wells, a quarry or place of extraction of natural resources;

7.1.3 The place of business must be ‘**fixed**’, that is to say, established and recognisable with a degree of permanency; and

7.1.4 The business must be ‘**conducted**’ or carried on through this place and according to the Commentary, a wide meaning should be given to the words ‘through which’, so as to include any of the business activities, wholly or partly, that constitute the business.

(my emphasis)

It is clear that the PE concept, as defined, is characterised by a physical *nexus* to, or presence in the country of source. Although the physical presence requirement has been relaxed over the years, this study maintains that the requirements to constitute a permanent establishment have not evolved sufficiently to embrace the unique attributes of e-commerce. Oguttu concludes,

“...that e-commerce enterprises can supply goods and services at non-arm’s length prices and avoid paying taxes in a source country as they will not be deemed to have a permanent establishment in that country.⁵”

Today the main three MTCs (OECD, U.N., U.S.) use similar wording in article 5(1) and prescribe the existence of a permanent establishment as the decisive condition for the taxation of income derived from business activities or capital in a country.

4 OECD, *Model Tax Convention with respect to Taxes on Income and Capital*, 2014, Article 3(1)(h).

5 AW Oguttu, *International Tax Law, Offshore Tax avoidance in South Africa*, 2015, at 537.

However, without there being agreement on an appropriate set of guiding principles to apply to e-commerce, the rationale and justification that entitles a country to impose tax on foreigners, in the absence of a permanent establishment, may also be contested.⁶ The question is, based on what rationale may a country apply its sovereign right to impose taxes on non-resident multi-national enterprises if they do not have a physical presence in a country and as a result do not use or utilise the infrastructure or services offered by that country. In the words of Harris and Oliver, “What sort of connection with the person is sufficient for this purpose?”

The general approach from an international tax perspective is that ‘source-based taxation’ is justified by the understanding that the country that provides the opportunity for a (foreign) enterprise to generate business profits should have the right to tax it. Cockfield, in referring to this question, submits that most motivations offered seem to be very subjective as to what the real rationale or connection or *nexus* is for a country to claim taxing rights.

Vogel is of the view that for a country to provide a market in which sales take place is sufficient validation to have a claim against those sales, in the form of a tax.⁷ According to International Tax the justification to tax non-residents lies in the principle of sharing the costs of the infrastructure and the running of a country which enables the production of income for the non-resident.⁸

Oguttu submits that the justification for a country to apply the source basis of taxation can be found on the presumption that it is a taxpayer’s duty, “to share the costs of running the country which makes it possible for the tax payer to produce an income.”⁹ Support for this argument is based on the *Kerguelen* case in which the Appellate Division noted that a country that makes its resources available is entitled to share in the wealth created by an enterprise in that country.¹⁰ It is questionable as

6 *International Commercial Tax*, by P Harris and D Oliver, 2010, Cambridge Tax Law Series, published by Cambridge University Press, at 46.

7 Klaus Vogel, *Worldwide vs. Source Taxation of Income – A Review and Evaluation of Arguments*, 1998, 11 Intertax 393 at 400.

8 *International Tax, A South African Perspective*, 2011 by L Olivier and M Honiball, Fifth Edition, p11

9 AW Oguttu, *International Tax Law, Offshore Tax avoidance in South Africa*, 2015, at 68.

10 *Kerguelen Sealing and Whaling Company Ltd v CIR*, 1939 AD 487, 10 SATC 363.

to whether these are convincing arguments to also apply to e-commerce as it appears to be based on guiding principles more suitable to the dynamics of the traditional economy.

According to Kemmeren, “The allocation of tax jurisdiction with respect to business profits based on the arm’s length principle flows prima facie from the principle of origin” and that “... the state of origin has the strongest, if not the exclusive, right to tax income from capital.”¹¹ Such statement, according to this report, infers the employment of capital by a foreign enterprise and does not necessarily relate to e-commerce. Kemmeren cautioned against the arbitrariness in international tax law which refers to the situation where there is no sufficient relationship between the state concerned and a non-resident enterprise and that state nonetheless impose tax.

One can understand that resident-based taxation is justified based on the principle that individuals and corporate enterprises being legally ‘resident’ in a country should contribute towards the public services provided for them by that country. However, do these arguments still carry adequate justification to tax non-residents without having a physical presence in a country? This study considers the views of Vogel and Kemmeren referred to above as being insufficient to establish taxing rights in the case of e-commerce and the reader is referred to the essential requirement of *nexus* or connection dealt with in 2.4, 2.5 and 3.1 above.

Is this not yet another example of how dated principles designed for the traditional economy are being forced on the digital economy? The outcry of the slogan “*No Taxation without Representation*” during the 1750s and 1760s springs to mind which was an expression that revealed the colonists’ anger at having to pay taxes without direct representation in the British Parliament.

¹¹ *Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach*, article written by Prof Dr Eric CCM Kemmeren, published in November 2006 in the IBFD Bulletin, at 436.

7.2 Response to the challenges of e-commerce

Before long, developments in information technology had allowed businesses to legally and in a rightful manner utilise traditional principles to generate tax benefits. The following are a few examples:

- Multi-nationals started consolidating foreign operations and reduce source country offices for customer support services which could be offered from outlying locations;
- The use of websites allows businesses to replace physical establishments;
- Using remote contracting and replacing agents; and
- Offering remote services from tax friendly jurisdictions.

These developments added to governments' concerns and prompted the OECD to intervene. The OECD made an attempt to address the issues with the explanatory guidance contained in the Commentary on Article 5. It was recorded that the place where automated equipment (for example, a computer server) is operated may constitute a permanent establishment but needs to be distinguished from data and software used by the equipment (for example, a website).¹² In the latter instance, the software and data is not tangible and as a result does not have a location and hence no permanent establishment.

Cyberlaw draws a distinction between the business of owning, controlling and operating a server(s) (ISP) on which websites are hosted and that of a business that merely rents space on that server platform in order for its website to be hosted through which it conducts its business. The latter case does not, in terms of the OECD, amount to the establishment of a PE.¹³

12 OECD Commentary on Article 5 *Concerning the Definition of Permanent Establishment*, paragraph 42.2.

13 S Papadopoulos and S Snail (Editors), *Cyberlaw @SA III, The Law of the Internet in South Africa*, Third Edition, at 106.

In order to extend the reach of the principle to take into account the unique features of e-commerce, the OECD laid down certain guidelines of which the following are relevant:

- A website *per se* does not constitute tangible property and therefore does not have a fixed place of business and thus does not constitute a permanent establishment;
- Website hosting facilities should not be deemed to be a permanent establishment for the enterprise conducting its business through the website;
- A computer server, if located at a specific place for a period of time is considered to be a fixed place of business through which a business is conducted and consequently considered to have acquired a permanent establishment;
- Internet Service Providers (ISPs) should not be regarded as agents and therefore ISPs, not being dependant agents, should not give rise to a permanent establishment of the enterprise making use of ISP services; and
- A communication link, advertising, relay of information through back-up servers, data collection and the supply of information are all regarded as ‘auxiliary and preparatory’ and are excluded from the definition of a permanent establishment.¹⁴

In summary, it is stated in *Cyberlaw* that although the guidelines in paragraphs 42.1 to 42.10 of the OECD Commentaries are useful, the application of substantive income tax rules to e-commerce remains a challenge.

Leading up to the OECD BEPS Project’s final reports the Task Force responsible for Action 1 (Addressing the Tax Challenges of the Digital Economy) examined the broader challenges of the digital economy. They discovered that there is a close link between the digital economy and the PE status requirement of *nexus* which was one

¹⁴ OECD, *Clarification on the Application of the Permanent Establishment Definition in E-commerce: Changes to the Commentary on the Model Tax Convention on Article 5*, Adopted by the Committee on Fiscal Affairs, 22 December 2000, at 5–7, added to paragraph 42 of the Commentary on Article 5.

of the principal issues scrutinised under Action 7 (Prevent the Artificial Avoidance of PE Status) of the BEPS Project.

During the stage of public discussion drafts and engagement with interest groups the OECD BEPS Project did consider the introduction of a digital permanent establishment and also examined a 'significant presence' test as an alternative to the traditional PE concept. In a public discussion draft paper in 2014 the Task Force reported that in order for a digital presence (alternative *nexus*) to be established, the following characteristics may be indicative of a digital business:

- The enterprise's main business relates largely to digital goods and services;
- Physical elements and activities for the creation and delivery of goods and services are restricted to computer hardware, servers and IT tools necessary to process it;
- Contracts are concluded electronically from a remote location via the Internet;
- Payment gateways which use primarily credit cards or similar electronic payment facilities;
- Websites are used as the only means to engage with customers;
- The greatest part of the enterprise's profits, that is to say, the core business, relates to the offering of digital goods or services;
- The legal or tax residence of the enterprise does not play a role and is largely irrelevant for the customers' decisions; and
- The goods or services can be used without the interface of a physical product.¹⁵

Action 1 of the OECD BEPS Project considered several proposals, one of which is to introduce a so-called new *nexus* to create a taxable connection in the case of a 'significant economic presence' in a country, taking into account the extent to which

15 OECD, Public Discussion Draft, BEPS Action 1: *Address the Tax Challenges of the Digital Economy*, (2014), paragraph 213, at 65.

an enterprise has a purposeful and sustained interaction with the economy through technology and other digital tools.

The following factors (with my emphasis) would demonstrate such a presence and may be considered individually or as a combination:

- **Revenue (as a basic and indicative factor)**

Revenues generated on a sustained basis from customers in a country may illustrate a significant presence in a country and as such establish the required *nexus*. This factor would be subject to certain qualifying criteria, for example:

- The number of transactions covered through which revenue is generated on the enterprise's digital platform;
- A threshold based on the total monetary value of transactions, that is to say, gross revenue; and
- The ability of a country to identify and manage the tax administration of sales and business activities of non-resident enterprises in that country.

- **Digital**

It is essential to determine how purposeful and sustained the interactions with customers are in a country and the following factors may be indicative of a presence:

- a local domain name, for example, the enterprise's home IP address may end with '.com' but to be more accessible to a host market in, say, South Africa, it may register a domain name ending with '.co.za'
- a local digital platform may be set-up in the country in question to attract local customers; and
- payment options in the local currency to enable local customers to flawlessly conclude transactions.

- **User base**

Data usage which is the amount of data, for example, images, documents, movies, music and files that are sent or received, downloaded or uploaded,

may be an important indicator of sustained interaction with the economy of a country and a range of factors based on users may prove to be useful, for example:

- active numbers of users of the electronic platform measured on a monthly basis;
- the number of online contracts concluded; and
- data and digital content collected (downloaded) by a user (customer) located in the country of source.

Other considerations that were also analysed, are the introduction of consumer or 'new source' taxes, for example, withholding tax levied on payments made by resident customers for goods or services bought online and the option of an equalisation levy to level the playing field between resident and non-resident enterprises and address disparity in tax treatment.¹⁶

None of these options were, however, recommended in the Final Report dealing with tax challenges of the digital economy and countries were given the discretion to implement any of these measures in their respective domestic laws.

Cockfield is of the view that the OECD has over time tried to force the traditional objective and intent of the permanent establishment concept into an economic presence test which in view of this report begs the question as to whether that is a viable reform approach. Furthermore, it might be very difficult to get consensus on some of these proposals as a number of countries have indicated that servers

¹⁶ OECD/G20 BEPS Project, Final Report, Action 1: *Addressing the Tax Challenges of the Digital Economy*, 2015, paragraphs 292 and 302.

should not be used to create a nexus whilst others promoted that websites should constitute permanent establishments.¹⁷

7.3 OECD BEPS Action 7

The objective in formulating the BEPS package was to ensure that profits are taxed where economic activities that generate these profits are carried out and value is created. Furthermore, the purpose was indeed to ensure that cross-border profits will be taxed which previously would have escaped the net or taxed at a very low rate.

The Final report of Action 7 is aimed at combatting the deliberate and artificial avoidance of PE status through the *commissionaire* (independent agent) arrangement, cases of exploiting the exceptions under Article 5(4) of the MTC and structured fragmentation of business activities or splitting of contracts across several jurisdictions, in order for it to qualify as auxiliary/preparatory activities and thereby avoiding the establishment of a PE. The recommended changes are not aimed at “changing the existing international standards on the allocation of taxing rights on cross-border income” and the view is that the effect of these reform proposals is restricted in that the concept of PE still relies on the key element of ‘physical *nexus*’ to a country.¹⁸

It appears that the BEPS proposals were driven to counter the artificial avoidance of tax and, instead of rewriting the definition of PE, did not adequately address the issue of non-taxation due to e-commerce which does not necessarily require a PE or physical presence in a state where business is conducted. This according Avi-Yonah is because even with the final reports, “the definition of taxable presence still rests on

17 Cockfield, A. J., Reforming the Permanent Establishment Principle through a Quantitative Economic Presence Test, 38 *Canadian Business Law Journal* (2003) 400.

18 OECD/G20 Base Erosion and Profit shifting Project, *Preventing the Artificial Avoidance of Permanent Establishment Status*, Action 7 – 2015, Final Report, at 14.

the obsolete PE concept...” and the recommendations under Action 7 do not deal (yet) with digital products.¹⁹

Wettersten concludes that the proposed changes do not solve the tax issues relating to business conducted by means of electronics, that is to say, e-commerce. However Wettersten argues that the option of a ‘significant economic presence’ test may be a step in the right direction as it refers to the digital presence in a country which may constitute the required *nexus*. She further continues to question whether it is time to replace the “traditional *nexus*-approach”.²⁰

7.4 Study response

Vogel made it clear that domestic law cannot contribute or add anything more to the definition as contained in a treaty definition.²¹ Therefore, if these rules of interpretation are followed and it remains uncertain, it may “indicate the non-existence of a permanent establishment.”

The OECD has acknowledged that the traditional and conventional application of the permanent establishment concept is no longer appropriate in dealing with today’s business needs.²²

In 2015, the OECD admitted that the digital economy has broader tax policy challenges which have a close link to the PE status requirement of *nexus*. This relates to the universal question of whether international tax rules deal appropriately with the digital economy to ensure that profits are taxed in the jurisdiction where business activities take place and value is created.

19 Evaluating BEPS, New York University School of Law, *Colloquium on Tax Policy and Public Finance*, by Reuven S. Avi-Yonah, University of Michigan Law School, 23 February 2016, at 14.

20 *How can the proposed changes to the OECD tax model convention in action 1 and action 7 counter the issue of an artificial avoidance of a PE status?* Master Thesis by Maria Wettersten, Lund University, School of Economics and Management, Department of Business Law, 2015/2016, at 21, 23 referring to an article in *Bulletin for International Taxation*, 2016 (volume 70) no. 3, at 9 by J. Francisco Bianco, R. Tomazela Santos.

21 Klaus Vogel on *Double Taxation Conventions*, Third Edition, Kluwer Law International, at 282.

22 OECD *Action Plan on Base Erosion and Profit Shifting 2013*.

In order to address the issue of cross-border e-commerce in instances where it is mostly not 'artificially' planned or structured for tax treaty benefits and which today happens all the time, due to market demand and technology making it possible, the definition of PE has to be amended to avert 'legitimate' non-taxation.

Based on that ground this study concludes that with regards to South Africa and other countries, the majority of (inward bound) cross-border e-commerce transactions with consumers (including businesses) escape income tax.

Apart from the definition of PE not providing adequately for e-commerce, tax administrations including that of South Africa face unique practical challenges to administer transactions in the digital economy. Hellerstein alluded to some of the difficulties and the following attributes of e-commerce illustrate the challenges that tax systems are faced with,

- Lack of central registration with authorities and the control thereof,
- The difficulty of identifying source, tracing origin and destination of transactions utilising weak and mostly encrypted digital correspondence between the business and the web enabling equipment,
- The nature of e-commerce enables the integration of business functions without human intervention or representation and at the same time allows for a fragmentation of economic activity often to jurisdictions that generate tax benefits,
- The extent of constant growth and rapid expansion in cross-border transactions, and
- The test for tax administrations to verify the parties to a transaction due to anonymity and the lack of clear audit trails.²³

In addition to these challenges, the view of this study is that certain fundamental requirements to establish a PE are lacking, for example, there is no 'place' of

²³ Walter Hellerstein, Francis Shackleford Professor of Taxation at the University of Georgia Law School, *Electronic Commerce and the Challenge for Tax Administration*, presentation to the World Trade Organisation in Geneva, Switzerland, 22 April 2002.

business, the place of business is not 'fixed' and there is no 'physical presence'. Furthermore, and as a consequence, the view is that there is no conclusive argument to justify a claim for taxing rights (*nexus*). These factors contribute to tax authorities not being able to enforce and administer corporate taxation on non-resident enterprises conducting cross-border e-commerce.

The view is that e-commerce and digital technology has to a large extent rendered the traditional concept of PE to become redundant.

Although the OECD efforts are commendable it appears, according to Avi-Yonah and other writers that the recommendations seem to be inadequate to counter issues relating to enterprises with a pure digital business model.²⁴ The effect thereof is that countries may have no foundation for a tax claim in the case of digital business.²⁵ Avi-Yonah is of the view that BEPS challenges will be addressed more effectively if active income is taxed primarily at residence, i.e. on a resident-basis as opposed to subjecting it to tax in the source jurisdiction.²⁶ The problem with such an approach is that it largely benefits developed countries which are predominantly also manufacturing and export countries at the expense of source jurisdictions, which are often developing countries.

²⁴ *Evaluating BEPS* by Reuven S. Avi-Yonah, University of Michigan Law School, series of sessions at the New York University School of Law Colloquium on Tax Policy and Public Finance, 23 February 2016.

²⁵ *How can the proposed changes to the OECD tax model convention in action 1 and 7 counter the issue of an artificial avoidance of PE status?* by Maria Wettersten, HARN60 Master Thesis 2015/2016, Lund University, School of Economics and Management, Department of Business Law at 28.

²⁶ Avi-Yonah, R.S., *Evaluating BEPS*, *New York University School of Law, Colloquium on Tax Policy and Public Finance*, 23 February 2016 at 3.

²⁷ Kemmeren, C.C.M. *Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach*, *IBFD 2006, Bulletin*

Another school of thought is to tax business profits of a multi-national enterprise in the country of source.²⁷ From an international tax perspective, the conventional rules by which the source of income is determined are either the statutory rules that will provide for the allocation of tax jurisdiction or common law based on the facts and circumstances doctrine.

Calvetti *et al* argue that corporate entities should be taxed in the countries in which they conduct relevant business activities and support the removal of the outdated PE concept by promoting the allocation of taxing rights among countries of source.²⁸ In support of 'source country taxation' they submit that the source of business profits is linked closely to where labour takes place, capital is devoted and expenses are incurred. They concluded that 'source country taxation' based on the actual business activities of corporations, "...are better suited to address the challenges of globalization and digitalization than any of the proposals that the OECD currently discusses in its BEPS project."

Kemmeren supports the source principle of taxation. He promotes the 'direct benefit principle' in that the "person who benefits from the public expenses incurred by a state should contribute to those expenses." Admitting that legal justification or *nexus* is essential for the right to tax, Kemmeren finds that connection in an economic relationship which the non-resident enterprise has with the state concerned. Ref He is of the view that an 'origin-based' interpretation of source is not only justified and feasible but also supports developing countries with collection of taxes and their economic development.²⁹

Kemmeren further opines that the concept of source should be interpreted based on the principle of origin and that substantial income-producing activities should be

28 *Why Corporate Taxation means Source Taxation*, A Response to the OECD's Actions against Base Erosion and Profit Shifting, by LU Cavelti, C Jaag and TF Rohner, 24 April 2016.

29 *Source of Income in Globalizing Economies: Overview of the Issues and a Plea for an Origin-Based Approach*, by Prof Dr Eric CCM Kemmeren, Professor of International Law in an article published by IBFD in November 2006, at 432.

taken into account to determine the economic location. Furthermore, he argues that the location of such economic relationship serves as the cause (*nexus*) of the income and hence justifies the strongest, if not exclusive, right to tax income and supports a principle of, "... no (production of) income, no income tax." Although, I am of the view that such an approach may be well suited for traditional cross-border transactions with an element of physical presence. This study considers it unlikely to be an effective and feasible solution for the unique attributes of e-commerce as the income-producing activities to demonstrate an economic relationship may be missing. The 'origin-based' approach in my view is based on facts and circumstances to substantiate the income-producing activities and relates to the engagement with a country's economy which ignores the unique concept of value creation through a digital presence.

An alternative approach is to find a new PE *nexus* that relates to the digital economy but which does not necessarily strengthen taxation at source. The key here is to reaffirm the principle of sovereignty and enhance taxing rights in the case of cross-border digital business activities. Hongler and Pistone, support the introduction of a new and additional provision in article 5 of the OECD MTC. Their proposed framework is designed to incorporate a new *nexus* into the PE concept which allows for a shift away from the physical presence association to one of value creation.

With value creation being the key determinant the authors focus on how to formulate a solution to tax business profits in case of the digital economy. Their view is that a new PE *nexus* will be established once the digital or physical presence of a non-resident business gives rise to 'value creation' in a foreign country. It is proposed that such new PE *nexus* could be introduced in the form of a new article 5(8) of the OECD MTC which should consist of the following main criteria,

- The existence of digital services by which access is provided to an electronic application or online facility,
- A minimum threshold to apply to the number of users in the host country, utilising the facility,
- A certain time threshold e.g. the number of users per month, and

- A *de minimus* amount of revenue, generated by such business, exceeding a set threshold.

Activities that meet these requirements will give rise to the status of ‘value creation’ and be deemed to constitute a digital presence. This will establish the PE *nexus* which is required to allocate taxing rights to the (host) country of source.

It appears from these widely divergent views referred to above including the OECD tax reform measures discussed earlier that there is no definitive rule or consensus on finding a suitable PE *nexus* for the digital economy.

Insofar as ‘artificial treaty shopping’ is concerned this study argues that in analysing cases of cross-border e-commerce pertaining to the PE status in a South African context, it is also relevant to refer to the common law principle that a business may ‘arrange its affairs so as to reduce the amount of tax payable’ and to use the cliché laid down by several judicial decisions³⁰ ‘that every man is entitled (to the extent permitted by law) to order his affairs so as to reduce the amount of tax payable by him’. The argument is hence that one must distinguish between,

- a deliberate and intentional avoidance of a taxable presence (a very aggressive form of structuring to avoid tax through treaty shopping in an artificial manner, that may be challenged by the principle of ‘substance over form’), in order to claim treaty benefits; and
- a case where a multi-national business adheres to principles of international taxation but by default these principles do not recognise a taxable *nexus* to allocate taxing rights.

Although it may be argued that a primary consideration for a country is to do what is best for its economy and which under certain circumstances may force a slight bias towards a tax system that protects a country’s tax base, discouraging an outflow of capital and resources, I believe that to have a set of rules applying to the traditional economy and another set of rules applying to cross-border e-commerce will be

³⁰ *IRC v Duke of Westminster (1936) AC 1 and Hicklin v SIR 1980 (1) SA 481 (A)*.

discriminatory and not comply with the fundamental principles of sound tax policy. Such an approach may even prove to be unconstitutional.³¹

Furthermore, the view is that the concept of source based on the principle of 'origin of economic activities' or source based on the 'direct benefit' principle fails the justification to tax, i.e. the *nexus* or connection in terms of which,

- the state has either contributed infrastructure and facilities enabling the process of income production giving rise to the tax, or
- the country has contributed to the abilities of the taxpayer producing income or in the alternative, a notion of social contract.

It is further submitted that, based on international tax principles to date of this study, without being able to constitute a permanent establishment, the country-of-source is not entitled to impose corporate tax on income of foreign enterprises even though these enterprises may earn business profits from e-commerce business activities in that country's jurisdiction. It may follow that the total amount of income under these circumstances may either be taxable in full or not at all, depending on the tax principles applied in terms of the domestic laws of the country-of-residence and/or the country-of-source.

Any change in domestic laws will require similar amendments to tax treaties which will require significant negotiations amongst states that may take considerable time to implement.

Finally, to adopt a principle to tax the business profits of multi-national enterprises in country of residence will deny many developing countries the right to claim (in many cases) well needed taxes.

7.5 Concluding remarks

In a presentation by IBM the aspects listed below, should be a cause for concern for tax administrators and policymakers considering the unique characteristics of the

³¹ *The Constitution of the Republic of South Africa*, 1996, Chapter 2, Bill of Rights, Section 9.

digital economy and illustrates the far-reaching consequences it may have in applying traditional tax principles, for example ‘permanent establishment’, ‘source’ and ‘resident’.³²

- “World’s largest taxi company owns no taxis (Uber)
- Largest accommodation provider owns no real estate (Airbnb)
- Largest phone companies own no telco infra (Skype, WeChat)
- World’s most valuable retailer has no inventory (Alibaba)
- Most popular media owner creates no content (Facebook)
- Fastest growing banks have no actual money (SocietyOne)
- World’s largest movie house owns no cinemas (Netflix)
- Largest software vendors don’t write the apps (Apple & Google)”

The peculiar features of many multi-national enterprises, today, demonstrate in my view that it is no longer unusual for business to have a virtual and no physical presence in several countries.

This study concludes that the emergence of the digital economy has affected the ability of taxing authorities to impose and collect tax on e-commerce transactions and corporate profits generated in a virtual and growing market.

The EU share the view of the OECD that the challenges posed by the digital economy lie in the difficulty to define tax jurisdiction without the need for a physical or legal presence and as a consequence, avoiding the PE status requirement. Commentators explain that governments are challenged more and more by multi-nationals with organisational structures that result in zero-tax and stateless income.

My view is that the rules have not kept up to date with technology and the developments giving rise to the growing digital economy and that even after the

³² Presentation made by Sandy Carter, IBM for Entrepreneurs event, The Digital Disruption Has Already Happened, reported by John Kennedy, *How digital disruption changed 8 industries forever*, 25 November 2015 and accessed on <https://www.siliconrepublic.com/companies/digital-disruption-changed-8-industries-forever>.

OECD's final report on international tax reforms published in 2015, the principle of taxing rights or the appropriate place to tax business profits with regards to e-commerce, remains a controversial subject.

South Africa is party to 87 DTA's in terms of which the country has agreed to the terms and conditions contained in these tax treaties. Of relevance in this context is Article 7 (1) that provides that a Contracting State will only tax the profits of an enterprise if such enterprise carries on business in South Africa through a permanent establishment. As South African domestic tax law recognises the concept of 'permanent establishment', the effect of these DTA's are that it limits South Africa's taxing rights as a Contracting State in the event of there being no permanent establishment.

This study has showed that a PE as per its current definition in Double Tax Agreements between South Africa and other Contracting States and which definition is aligned with the OECD Model Tax Treaty, requires a physical presence or PE *nexus* which is not a requirement necessary to conduct e-commerce via the Internet in a host country.

The fundamental justification for a government to impose taxes is according to International Commercial Tax based on the services provided by a government.³³ A government has "...no justification, no jurisdiction to tax unless there is an appropriate connecting factor, i.e. a recognised basis of economic allegiance." This study contends that the activity giving rise to e-commerce business profits and the geographic location thereof do not by virtue of technology, necessary take place in the country where a transaction is concluded. It is submitted in the alternative, that a foreign enterprise does not benefit from services provided by the host government and as a consequence there is no connecting factor.

³³ *International Commercial Tax*, Tax Law Series by P Harris and D Oliver, 2010, published by Cambridge University Press, at 43.

It is submitted that there is merit in formulating a new PE *nexus* allowing for the allocation of taxing rights on cross-border business profits. Such a reform measure will allow the state of source to preserve its sovereignty on the taxation of business profits that are derived by foreign enterprises relating to activities effectively linked to its jurisdiction.

The impact of the digital economy on tax principles has to be addressed. A good starting point may be to also recognise a foreign enterprise's digital presence (an 'impermanent establishment' or 'virtual permanent establishment') by expanding the conventional physical presence concept. This could be achieved with the adoption of a new Article 5(8) in the OECD Model Tax Convention based on a paper presented by P Hongler and P Pistone. The objective should be to define 'virtual presence' based on the principle of 'value creation'. Such a definition may include the following criteria:

- An enterprise resident in one Contracting State that has a digital business facility or presence in another Contracting State will be deemed to have a virtual establishment in that other Contracting State,
- The digital business facility must be suitably qualified to provide access to a web-based electronic application, that is an online market store, advertising or database,
- Such facility must reflect a substantial and ongoing interaction with the economy of that other Contracting State, that is an engagement with consumers, resident in that other Contracting State, using the facility,
- Certain *de minimis* thresholds may be implemented for example, a minimum number of users and the total amount of revenue generated per annum by virtue of the said facility.³⁴

31 Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy, working paper by Peter Hongler and Pasquale Pistone, 20 January 2015, published by IBFD.

The adoption of a new 'virtual permanent establishment' principle by states will be made easier if a universally recognised and accredited 'world tax organisation' can be established in future. It is considered that the OECD could play this role.

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