

**THE TAXATION OF E-COMMERCE: AN EXAMINATION
OF THE IMPACT AND CHALLENGES POSED BY
ELECTRONIC COMMERCE ON THE EXISTING TAX
REGIME**

BY

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DECLARATION

I hereby declare that the whole of this thesis, save as specifically acknowledged in the text, is my original work, and has neither been published elsewhere nor submitted in any other University.

Naicker Signed this 25 day of August 2003

Kershnee Naicker at Pietermaritzburg, Natal

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My thesis is dedicated in memory of my brother, Thergan. I miss you.

ABSTRACT

Rapid advancements in communications technology and the development of the Internet into a global 'network of networks' are said to be drivers of the 'new economy'. The access to these networks have stimulated the emergence of 'cyber business' and 'electronic commerce'. In the world of cyberspace, this 'new economy' represents a channel, rich in information, choices, opportunities, entertainment, knowledge, and commerce. It has changed the manner in which society works and interacts, whilst embracing the commercial sphere. The 'net' may be seen as an instantaneously accessible global shopping mall. Thus, there is a need to understand the problems associated with this new technology. As e-commerce continues to boom, globalisation presents new challenges to governments around the world, tax policymakers and administrators with regard to the application of existing tax norms. Whether or not the Internet continues to be a driving force behind the economy depends upon the policies, regulations, and taxes imposed on this new medium. The fact that the existing tax laws were developed to deal with the trading of physical goods or the provision of services to clearly identifiable persons, and not with the borderless, faceless nature of electronic commerce, tax authorities must reach an international consensus and clarity on which taxing jurisdiction may collect taxes, when businesses and individuals are transacting online. Characterisation of income is important because national and international income tax rules assign different categories of income to different jurisdictions. The concept of 'permanent establishment' is based on a physical presence, which may be more difficult to apply with the modern communication systems. Due to the increasing rate at which multinationals share central services and business development activities, the transfer pricing issue is one of determining an appropriate price or value of transactions undertaken between related parties. These issues need to be examined by, among others, the OECD. It has yet to reach definite conclusions, but drafts of its

working papers, made public, suggest a chief focus of the OECD work will be to clarify transactions in cyberspace.

This thesis critically examines the ability of the existing tax legislation, within the context of the Income Tax Act 58 of 1962, to the challenges posed by trading on the Internet. An examination of the impact of tax principles on e-commerce is prefaced by an analysis of international response to this subject. The basic structure of the Internet, e-commerce and its functioning is examined. These daunting challenges and the controversial sets of issues are powerfully documented in this thesis, up to and including the enactment of the Taxation Laws Amendment Act 30 of 2002, which took effect on 13 December 2002.

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CHAPTER ONE

INTRODUCTION

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1.1 THE SCOPE OF THIS STUDY

Tax authorities have always been faced with the daunting task of trying to combat intelligent tax evasion schemes whilst overcoming increasingly sophisticated anti-avoidance legislation. These threats to the traditional tax systems have been compounded by a new challenge, arguably the biggest challenge to date, viz 'Electronic Commerce.'

Online trading poses a number of challenges for the existing tax framework. This thesis approaches the subject of taxing electronic commerce by examining the existing income tax principles and how they apply to trading over the Internet. As a background, to appreciate the complex challenges that e-commerce presents to tax principles, a solid understanding of the basics of the Internet is required. This thesis provides an overview of electronic commerce and a brief explanation of how and what happens when e-commerce is conducted. Due to this new form of business, there remain several key issues that are unresolved and, whilst they present problems for taxing authorities and administrators, they also present opportunities for legitimate tax planning whereby businesses can reduce their tax payments in some or all countries in which they operate. Against this background, this thesis will consider and examine the impact of the Internet and e-commerce on the established taxation principles and the ability of the existing tax regimes to cope with these new realities. The following income tax principles will be addressed in detail: The concepts of 'source' and 'residence' are the cornerstone of

international tax principles, as they are used to determine whether or not income is taxable in a country. No geographical boundaries exist in cyberspace resulting in the concepts of source and residence becoming difficult to apply. An analysis of the theories of 'source' and 'residence' will be carried out. Determining the residence of a company may prove difficult as the management of companies may be situated in a multiplicity of countries by which they are communicating electronically without any head office or other central control, therefore a discussion ensues on the 'residence' of companies. With the global nature of e-commerce, double taxation is likely to result in electronic transactions. Traditionally, the concept of 'permanent establishment' required some physical presence in the country seeking to impose tax. Today, however, it is no longer necessary to have a physical place of business in a country in order to sell products or services in that country. This phenomenon has raised a discussion on whether the traditional concept of 'permanent establishment' remains workable or if a change is indeed necessary. Traditionally, countries have developed different rules for different types of income. For example, the rules for determining the right to tax income from services may be different from the rules for determining the right to tax royalties. Similarly, the rules for determining the right to tax income from sales may be different from the rules for taxing royalties. Such distinctions become challenging in the light of e-commerce. As e-commerce facilitates cross-border trade, particularly for businesses who may have 'web' subsidiaries, transfer pricing issues will occur more frequently and, in the view of advances in communication technology may be more complex. Thus, e-commerce poses a serious threat to the traditional arm's length principle

In addition to an examination of the above issues, it will be illustrated, by way of a practical e-commerce example, how transactions could give rise to tax consequences in

the e-commerce environment. The example illustrates the application of the existing tax principles to the problems and challenges of online trading. The concluding chapter of this thesis builds upon the foregoing chapters and draws upon the findings and conclusions of the preceding materials and related sources.

1.2 METHODOLOGY

The research methodology of this study may be classified as analytical and from a legal perspective. Any inferences into other disciplines are merely incidental. The principal difficulty in researching this subject matter is the relative infancy of electronic commerce, and the corresponding shortage of literature on this topic. However, various tax administrators have released policy documents on electronic commerce.

A review of the literature on the taxation of electronic commerce available at the library of the University of Natal, Pietermaritzburg, and Durban was carried out. In addition, the Sabinet database was searched for relevant literature. In the Sabinet database, ISAP was searched for relevant literature in journals and periodicals, in UCTD for dissertations and thesis, in MEDIA for newspaper clippings and in SACAT for books. The additional literature was sourced from other institutions using the inter-library loan facility. Thereafter, the EBSCOhost and WESLAW database was searched for full text articles relating to the topic. The Internet was also searched as a secondary source of information.

This thesis will only focus on the income tax implications of electronic commerce on tax systems. While it is acknowledged that Valued Added Tax, customs duties, and

compliance and administrative issues are vital to the taxation of e-commerce, the effect of these indirect taxes and administrative issues will not be addressed in this thesis.

Chapter 2 begins by introducing the concept of e-commerce. ~~It further highlights what~~ the Internet is, together with its related functions and parties. The focus of the chapter is to stimulate a good understanding of electronic commerce before considering the implications of this new form of business.

Chapter 4 sets out the reaction of tax policymakers and administrators to the pressures that e-commerce place on their tax regimes. The chapter examines the discussion papers issued by the United States of America, United Kingdom, Australia, South Africa and the various organisations being the Organisation for Economic Co-operation and Development, and the European Union, on this matter. The chapter lays down a legal theoretical foundation, which forms a logical lead to the next discussion on taxation laws.

In chapter 5 income tax issues relevant to the South African tax principles and e-commerce are discussed. Central to this discussion is adapting the application of existing tax principles, practices, and procedures to an e-commerce environment. An examination of income tax principles namely, source and residence, double tax agreements; permanent establishment; characterisation of income and transfer pricing, is conducted to detail the complexities in enforcing the conventional tax laws to electronic transactions.

The focus of chapter 6 is to illustrate the dynamics of applying the tax principles already discussed in chapter 5 to an e-commerce practical example. This also identifies some of the difficulties in applying existing concepts to income generated from e-commerce. The

chapter further highlights the application of tax legislation, procedure, and practices to the realities of trading online, and focuses on ambiguities and complexities, in current regulations. This chapter also offers some possible approaches to the taxation of electronic commerce.

This thesis concludes with a consideration of some of the areas, which are likely to come into discussion when possible adaptation of rules will be undertaken.

"In this world nothing can be said to be certain, except death and taxes"

Benjamin Franklin

CHAPTER TWO

WHAT IS THE INTERNET?

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While it is beyond the scope of this thesis to discuss the complex functioning of the Internet and its workings, a basic understanding of certain parts is imperative in order to comprehend the tax issues raised in this thesis. This chapter considers the definition of the Internet and E-commerce, examples of electronic trading, how the Internet functions and the 'electronic commerce' transaction.

2.1 A Definition of the Internet and E-commerce

The United States Department of Treasury defined e-commerce as 'the ability to perform transactions involving the exchange of goods and services between two or more parties using electronic tools and techniques.'¹

Benzine and Garland define the Internet as 'the world wide network of networks that are connecting each other into a single logical network all sharing a common addressing scheme.'²

¹ United States Department of Treasury (1996) para 3.2.1.

² Buys (2000) 11.

The term 'electronic commerce' refers to the 'modern business use of computers that fulfills the need of firms, customers, and management to provide a more efficient delivery of goods and services.'³

2.2 Examples of Electronic Trading

The activity in an e-commerce transaction may take place between individuals of several relationships i.e. consumer-to-consumer, consumer-to-business, business-to-businesses, or intra-business. A large number of companies are currently using the Internet to perform a variety of business functions. The applications currently available for the consumer marketplace include five broad categories: entertainment, financial services, information, essential services, and education and training. Each of these categories break down into smaller groups consisting of the actual commercial activities transpiring (e.g. advertising, banking, legal advice, providing software or movies capable of being downloaded directly to a user's computer). The following are short descriptions of some of the more prevalent types of transactions occurring on the Internet⁴:

Retailing and Wholesaling: These web sites act as supplements to or replacements for paper catalogues sent by mail order companies and wholesalers. The web sites provide special links to company inventory which allow the user to view stock availability. Users may purchase through submission of electronic purchase forms containing the user's credit card information, through electronic cash,⁵ or by a purchase form with payment on the delivery of the goods.

³ Doernberg, Hinnekens, Hellerstein & Li (2001) 37.

⁴ United States Department of Treasury (1996) paras 3.2.2-3.2.10.

⁵ Electronic cash involves tokens of value expressed in digital form. United States Department of Treasury (1996) para 5.3.

Computer Software: A web page advertises the computer software for sale. Following payment by submission of the customer's credit card details or electronic cash, a customer may directly download the software to his computer.

Photographs: Users may buy various rights (e.g. licenses) to pictures located at a web site which they may then directly download to their computer terminal. The user may make payment through submission of the user's credit card details or the transfer of electronic cash.

Online information: This category encompasses electronic research databases⁶ which the user can access through the Internet. User fees may be calculated according to pre-selected option plans - by individual search, by specific periods of time (e.g. minute or hour increments), or on a monthly, flat rate basis. Users commonly make payments using non-electronic methods such as checks or credit cards.

Services: Most of the services occurring online involve providing or obtaining general consulting advice from professionals such as lawyers and accountants. Many of the businesses supplying these services do not charge users, but instead utilise the web pages as marketing tools to attract clients to their firms.

Health Care: This involves communications between health care personnel⁷.

Electronic Gambling: Gambling has become a booming commercial business on the Internet. While often linked directly to a bank on the Internet for making and receiving payments, the user may also purchase casino chips electronically using electronic cash, or have his bank transfer funds into the casino's account or receive funds from the casino in the regular manner after the gambling session is complete.

⁶ For example, LEXISNEXIS, WESLAW and DIALOG.

⁷ One such example is www.proservices.com, which is a free database of health questions and answers.

Stock Trading/ Purchase of Securities: Stockbrokers and their specialised computer systems are no longer a necessity as users can now perform the transaction themselves with just a few key strokes.⁸

2.3 How does the Internet function?

The Internet can be broken down into two parts: one the physical network infrastructure and the other logical network infrastructure. The physical network infrastructure refers to the physical components (user, computers/ terminals, cables, routers and servers) that allow computers to transmit information to each other. The logical network infrastructure makes that communication possible.⁹ The logical network infrastructure 'can be thought of as the laws that govern the movement of traffic down the network highways'¹⁰ and refers to the actual method by which information is transferred from one computer to another. Moving information between computers and servers involves the use of terminals, servers, routers, and domain names. Servers are maintained by information providers (publishers) and are essentially computers which act as depositories of electronic data (files full of information) that can be simultaneously accessed by independent users from anywhere in the world through the use of a browser.¹¹ A domain is the unique name that identifies an individual Internet site, by acting as an address.¹² Routers are specialised computers which act like post offices, reading the delivery addresses on electronic information being transported from one computer to another, and sending it on its way via the most efficient route. Electronic information (files or

⁸ [Http://www.Daket.com](http://www.Daket.com) is an example that makes available services related to the purchase and sale of stock and securities.

⁹ Thorpe (1997) 33. See also Doernberg, Hinnekens, Hellerstein & Li (2001) 16-25.

¹⁰ Ibid.

¹¹ Craig (2001) 4.

¹² Doernberg, Hinnekens, Hellerstein & Li (2001) 30.

messages) is transferred from one Internet address (domain name) to another by splitting it into smaller packets and labeling them, similar to addressing a postal letter. The Internet Protocol side of TCP/ IP (Transmission Control Protocol/Internet Protocol) labels each packet with a domain name of the destination computer and the Transmission Control Protocol side assigns a sequence number to each packet. This is done since the packets may travel separate routes, arriving at different times. The sequence numbers tell the TCP/IP in the destination computer in which order to reassemble them once they arrive. Each router reads the IP address of the packets and decides which path will be the fastest at that time.¹³

The Internet also functions by means of various programs. At the computer/ terminal level, the local user runs an application program, known as a Client.¹⁴ The Client¹⁵ program resides on the user's computer or terminal and enables the user to contact and obtain data from a server, often across a great distance.¹⁶ A browser is a specific kind of Client program that is used to look at various kinds of Internet resources.¹⁷ These Client programs may allow the user to view the text off a server¹⁸ or provide a graphical interface allowing the user to view pictures.¹⁹ The World Wide Web (www) is an Internet navigation tool based on hypertext²⁰ transfer protocol (HTTP)²¹ used for locating and accessing information in a multimedia format (colour, graphics, audio, and video)

¹³ Thorpe (1997) 37.

¹⁴ Ibid.

¹⁵ An example of a 'Client' is America On Line (AOL), CompuServe and M-web.

¹⁶ Thorpe (1997) 37 . The term 'server' refers to either a software package that provides a specific kind of service to client software running on other computers or to an actual machine on which the software is running.

¹⁷ Doernberg, Hinnekens, Hellerstein & Li (2001) 30.

¹⁸ For Lynx.

¹⁹ For example Netscape Communication's Navigator or Microsoft's Internet Explorer.

²⁰ Hypertext is the text that includes links or shortcuts to other documents, allowing the reader to easily jump from one text to related texts, and consequentially from one idea to another, in a non-linear fashion.

²¹ HTTP is a simple request/response protocol that is run over TCP and forms the basis of the World Wide Web.

available on the hard drives and other storage facilities of computers, known as web servers, on the Internet. Users can access the Web through web browser software, as mentioned above. The web enables the user to follow 'hyperlinks'²² from one document to another, by clicking with their mouse on a word or picture on an electronic page. The documents contain text, graphics, audio, and video files, and are organised using a set of instructions called hypertext markup language (HTML). Through the use of a browser, the web allows users to explore a wide variety of topics and issues. A company's or an individual's collected web documents are usually referred to as a 'web site' (or page) and are the location from which and to which messages and information are delivered on the world wide web.²³ Since the Web is the most popular vehicle for online commerce today, much of this thesis will center around transactions as they transpire through the use of the Internet.

Essential to any discussion of the international taxation of electronic commerce is an understanding of how income is earned over the Internet. There are two major sources of Internet generated revenue: advertisements and direct sales.²⁴ Certain providers of information or 'content' earn revenue from advertisements. Content providers who earn advertising revenue place paid advertisements on their web sites in the same manner that newspapers or magazines place paid advertisements on their printed pages. Services are also provided over the Internet. A number of law firms, accounting firms, and other professional service providers are using the Internet as another means of

²² Thorpe (1997) 39. A hyperlink is an address embedded in a document that when clicked on with a pointing device takes the user to another document at the new address.

²³ Muscovitch (1997) 5.

²⁴ United States Department of Treasury (1996) para 5.1.

selling their services to clients.²⁵ The unifying feature of these businesses is that they make their money by developing or acquiring content that will attract viewers to their web sites. The second principal type of revenue earned through the Internet is from 'Electronic Trading' or the provision of goods or services via electronic interaction. The degree of electronic involvement in these purchase and sale transactions can vary, arguably with different tax consequences. For example, suppose that a customer accesses the web site of a book retailer²⁶ and identifies a book that she wants to purchase. The customer could place her order over the telephone and arrange for the book to be delivered through the mail. Alternatively, the customer's book could be delivered through the mail, but the customer could ask and receive answers about her purchase, order the book, have her order accepted and make payment over the Internet. In addition, the customer could not only place her order and pay electronically but also arrange for the book to be delivered electronically to the hard drive on her personal computer. The company from which the customer purchases her book could be an exclusively electronic retailer with no physical stores or a conventional book retailer that uses the Internet as an additional outlet to sell its product. Electronic trading is hardly restricted to books. Businesses are increasingly viewing the Internet as a means of making their relationships with suppliers, distributors, and customers more efficient.

2.4 The 'Electronic Commerce' Transaction

When a purchase is made over the Internet, it most likely takes one of two forms: the purchase is made either between an individual consumer contracting with a business software agent (consumer-business), or between two businesses contracting together (business-business). Normally, a potential customer on the Internet will interact with a

²⁵ An example of a law company is <http://www.mbendi.co.za>.

²⁶ <http://www.amazon.com>.

software agent when purchasing something on a web site. Generally, a software agent is a programmed agent of a principal (such as business) that performs various programmed duties for the principal.²⁷ Therefore, when visiting the Internet web page the customer interacts with the software agents, which have been programmed to enable the customer to make informed decisions about a product before deciding whether or not to purchase that product. The software agent furnishes information, displays pictures, and provides web pages containing other pertinent information. Once the customer decided to buy the product, the software agent would then bind the business and the customer to an agreement to provide the services for the appropriate consideration.

'We had better pay attention to the future – After all, that's where we will spend the rest of our lives.'

Albert Einstein

²⁷ Schaefer (1999) 120.

CHAPTER THREE

INTERNATIONAL RESPONSE ON THE TAXATION OF ELECTRONIC COMMERCE

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3. International Thinking on the Taxation of Electronic Transactions

The taxation of e-commerce is a global challenge for both governments and businesses alike. Both national governments and international organisations have responded to the challenges posed by e-commerce. They have been tasked with monitoring these challenges and searching for an appropriate tax framework to deal with the developments of e-commerce, to ensure a fiscal environment is provided within which electronic commerce may flourish. The responses of the United States of America, United Kingdom, Australia, South Africa, the Organisation for Economic Co-operation and Development, and the European Union as regards the taxation of e-commerce are discussed in this chapter.

3.1 United States of America

In July 1997, the White House released a paper entitled a 'Framework for Global Electronic Commerce' and in November 1996, the United States' Department of Treasury issued a paper 'Selected Tax Policy Implications of Global Electronic Commerce'. The executive summary described the important aspect as follows:

'In order to ensure that these new technologies not be impeded, the development of substantive tax policy and administration in this area should be guided by the principle of neutrality. Neutrality rejects the imposition of new or additional taxes on electronic transactions and instead simply requires that the tax system treat similar income equally, regardless of whether it is earned through electronic means or existing channels of commerce.

A major substantive issue raised by these new technologies is identifying the country or countries which have the jurisdiction to tax such income. It is necessary to clarify how existing concepts apply to persons engaged in electronic commerce. In addition, transactions in cyberspace will likely accelerate the current trend to de-emphasize traditional concepts of source-based taxation, increasing the importance of residence-based taxation.

Another major category of issues involve the classification of income arising from transactions in digitized information, such as computer programs, books, music, or images. The distinction between royalty, sale of goods, and services income must be refined in the light of the ease of transmitting and reproducing digitized information.'²⁸

3.2 United Kingdom

In October 1998, the Inland Revenue and HM Customs and Excise issued a joint paper on the United Kingdom tax policy regarding e-commerce entitled 'Electronic Commerce UK Policy on Taxation Issues', whereby they undertook 'to work with international

²⁸ United States Department of Treasury (1996) 1.

institutions and the private sector to offer the best opportunities for the future: a predictable and stable environment and a seamless, decentralised global market place where competition and consumer choice drive economic entity.²⁹ The United Kingdom emphasised the following principles: certainty about tax rules, effectiveness and efficiency, prevention of double or unintentional (non) taxation and low compliance costs. A major policy principle for the United Kingdom is that the rules and procedure should aim to be neutral between e-commerce and conventional forms of commerce so that no form of commerce is advantaged or disadvantaged, and the government must receive international cooperation in the implementation of any new tax policies, and they must develop a system that not only encourages the growth of e-commerce in the United Kingdom, but also does not step on the toes of the international community in which cooperation will be required for effective enforcement.³⁰

3.3 Australia

The Australian Taxation Office has issued a report on electronic commerce in 1997 and a second report in 1999, captioned 'Discussion Report of the Australian Taxation Office Electronic Commerce Report'. The important theme emerging from these reports are that there should be 'neutrality' between the taxation of e-commerce and other forms of commerce.

3.4 South Africa

The first reference on the taxation of electronic commerce in South Africa may be found in the Katz Report.³¹ The Katz Commission reports that:

²⁹ Inland Revenue of the United Kingdom (1998) 2.

³⁰ Ibid.

³¹ The Fifth Interim Katz Commission Report which was released in March 1997.

(electronic commerce) developments will affect 'some of the basic tenets of international taxation, as they exist today. It would be premature now to introduce an entirely new regime of international taxation which seeks to cope with these developments.' The commission further states that 'to seek a pioneering role here would be both arrogant and dangerous.'³²

The Director General, Andile Ngcaba, stated that the current legislation is insufficient to cope with the boom in e-commerce, particularly when it comes to the borderless nature of the Internet, stating the following: 'it is widely accepted that the strong encryption and the ability to move money instantaneously across the planet will undermine the ability of the government to tax their citizens.'³³ The South African government, under the leadership of the Department of Communications, has recently embarked on a process to develop a discussion document on electronic commerce – 'The Green Paper' on electronic commerce which was released by the Communications Minister Matsepe-Casaburri in November 2000.³⁴

The paper explored issues around e-commerce and taxation including the classification of income, source based versus residence based taxation, administrative and compliance issues. The Green paper's chapter four is primarily concerned with preventing a shrinking of the government's tax base and the possible reduction of fiscal revenue while installing a tax system, which is fair and does not distort the conduct of business. However, it is submitted that the chapter does not expand on the meaning of 'fair' in this context, and fair towards whom. The Green paper on electronic commerce claims that the South African challenge is 'to develop a tax policy that is not isolated from

³² Katz Commission (1997) para 7.4.

³³ Ensor (1999) 1.

³⁴ The 'Green Paper' which is available at <http://www.ecomm-debate.co.za>.

its e-commerce partners³⁵ but does not make any mention of South Africa's social situation and how this might be incorporated in the taxation of e-commerce ventures.

Section 4.2 of the Green Paper on electronic commerce looks in greater detail at how e-commerce is handled on an international level, and inquires how these international principles should be incorporated in taxation of e-commerce in South Africa.

The international principles of taxation appear to be more concerned with government revenue rather than the problems of e-commerce entrepreneurs, and such an approach may not be entirely appropriate in South Africa's social and economic context. KPMGs' response to the Green Paper on E-commerce is that where the government have not issued guidelines regarding taxation of income, the OECD principles need to be consulted to give indication of the international approach.³⁶ It was noted that the United States principles are not the same as the OECD principles. The general principles of the OECD regarding taxation of e-commerce should be taken into consideration by the government with due regard to the economic and social conditions applying to South Africa effectively. Thus, the government is advised not implement policies which conflict with international standards.³⁷ Not following international principles may result in South Africa being excluded from international trade and foreign investment with regard to e-commerce.

3.5 The Organisation for Economic Co-operation and Development

The Organisation for Economic Co-operation and Development (hereinafter referred to as the 'OECD') is a 29-member group of leading industrialised nations. Even though it

³⁵ Department of Communications (2000) 22.

³⁶ KPMG (2001) 13.

³⁷ Ibid.

obviously cannot enact legislation, its actions are being watched with intense interest because of its leadership role in acting as a forum for coordinating tax policies.³⁸

The OECD has held two conferences to study taxation and electronic commerce, namely the Turku, Finland Conference in November 1997 and the Ottawa, Canada Conference in October 1998. The Turku Conference concluded that the committee on fiscal affairs of the OECD should be the international body to co-ordinate and progress taxation issues of electronic commerce. It has the task of developing the taxation framework conditions that are applicable to e-commerce. Following the Ottawa Conference, the OECD launched a work programme, which established five Technical Advisory Groups aiming to assist governments to protect their revenues and at the same time foster positive business. The plan is for the ultimate product to be globally acceptable.³⁹

The Committee on Fiscal Affairs of the OECD has suggested that the following general tax principles be used as a yardstick when applying policy regarding tax law and the Internet:⁴⁰

a) Broad Taxation Principles:

Neutrality

Taxation should seek to be neutral and equitable between all forms of electronic commerce, and between conventional and electronic forms of commerce. Business decisions should be motivated by economic rather than tax considerations. Taxpayers in similar situations, carrying out similar transactions, should be subject to similar levels of taxation.

³⁸Westin (2000) 532.

³⁹ OECD Electronic Commerce (1998) 6.

⁴⁰ Ibid 7-8.

Efficiency

Compliance cost for taxpayers and administrative cost for the tax authorities should be minimised as far as possible.

Certainty and simplicity

The tax rules should be clear and easy to understand so that taxpayers can anticipate the tax consequences of a transaction in advance, including knowing when, where and how the tax is to be accounted.

Effectiveness and fairness

Taxation should produce the right amount of tax at the right time. The possibility for evasion and avoidance should be minimised, and counter-acting measures should be proportionate to the risks involved.

Flexibility

The systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments.

Furthermore, the Committee on Fiscal Affairs has identified other areas for inclusion in the taxation framework for electronic commerce. These include:

b) Consumption Taxes

Rules for the consumption taxation of cross-border trade may result in taxation in the jurisdiction where consumption takes place, and an international consensus should be sought on the circumstances under which supplies are held to be consumed in a jurisdiction. The supply of digitised products should not be treated as a supply of goods for the purpose of consumption taxes. Where business and other organisations within a country acquire services and intangible property from suppliers outside the country,

countries should examine the use of reverse charge, self-assessment, or other equivalent mechanisms when needed.

c) There should be no discriminatory tax treatment of e-commerce.

d) The application of these principles should maintain fiscal sovereignty of countries, ensure a fair sharing of the tax base, and avoid double taxation or unintentional non-taxation.

e) Putting flesh on these principles should involve intensified co-operation and consultation with economies outside the OECD area, with business and with non-business taxpayer groups.⁴¹

The above framework is not at odds with the views held by the South African Revenue Services but care should be taken to ensure that the existing South African tax base is not eroded by international decisions favouring nations with sophisticated and developed economies.

3.6 The European Union (EU)

The European Union has released its 'Initiative in Electronic Commerce' in 1997. The Commission was concerned about business competition from abroad, especially with United States. The Initiative states that the EU's primary objective for e-commerce is to build a proper regulatory environment. The Initiative also seeks:

- Consistent, workable regulations for contracts and e-payments;
- Movement in the direction of a global regulatory framework;
- Clear and neutral tax environment that offers certainty and neutrality.⁴²

⁴¹ Ibid.

⁴² European Commission (1997) 10.

3.7 Conclusion

No international institution has yet made concrete proposals aside from stating that there is a need for neutrality and that no new taxes must be implemented. The United States, United Kingdom, and OECD adopt similar principles. They recognise the need for a coordinated multinational approach to e-commerce to avoid the possibility of double or non-taxation and that taxation should not be permitted to be a barrier to the growth of e-commerce.

"It is not the strongest of the species that survives nor the most intelligent, it is the one that is most adaptable to change."

Charles Darwin

CHAPTER FOUR

THE IMPACT OF EXISTING INCOME TAX PRINCIPLES ON E-COMMERCE

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4. Introduction

The application of the existing tax regime is generally incapable of adequately taxing electronic transactions and must be adapted, or else governments will face a significant decrease in their tax revenues and an uncertainty in determining a country's jurisdiction to impose tax, as more and more commercial transactions take place over the Internet. Clearly, the shift from a physically oriented commercial environment to a knowledge-based electronic environment, presents some serious and substantial issues, which require attention. This chapter examines the impact of income tax uncertainties arising from electronic commerce. In particular it will focus on whether the existing principles of source and residence; permanent establishment; characterisation of income; and transfer pricing can be applied to e-commerce transactions conducted over the Internet.

4.1 The Concepts of Source and Residence

The traditional model for international taxation of global commerce is based upon the concepts of residence of a taxpayer and source of income. Residence-based tax is a type of tax system, which taxes residents of the country on their world-wide income having no regard to the source of the income. The source of income is where the economic activity creating the income occurs. The clarity between these two principles lies at the heart of the electronic commerce debate due to the complex, intangible, and multi-jurisdictional nature of e-commerce.⁴³ According to Mauro, whether to tax goods at the source or residence country is an unresolved issue related to double taxation as the traditional physical presence test of a business no longer holds.⁴⁴ Therefore, the current international debate is whether 'source' and 'residence' concepts are still both equally appropriate in the electronic economy or whether one of these concepts is more relevant than the other.⁴⁵

The following section will consider the principles of 'source' and 'residence' and how effective they are in an e-commerce environment.

4.1.2 Sourced-based versus Residence-based Taxation

From 1962 until 1997, the Income Tax Act 58 of 1962 (hereinafter referred to as 'the Income Tax Act') was based on the source principle.⁴⁶ In 1997, the Minister of Finance, Trevor Manuel relaxed foreign exchange allowances for South African resident taxpayers. This led to the implementation of sections 9C and 9D. On 22 February 2000, section 9E⁴⁷ was included in the Income Tax Act in order to tax foreign dividend receipts of South African resident taxpayers. The complete residence-based taxation system was

⁴³ Mauro (2000) 1.

⁴⁴ Mauro (2000) 5.

⁴⁵ Zeff (2000) 22.

⁴⁶ See ss 9, 9A, 9C and 9D of the Income Tax Act.

⁴⁷ The Taxation Laws Amendment Act 30 of 2000 introduced section 9E.

implemented for companies and trusts with the years of assessment commencing on or after 1 January 2001 and for individuals with effect from 1 March 2001 i.e. the 2002 year of assessment. Prior to 1 January 2001, the gross income definition contained in section 1 of the Income Tax Act read as follows:

'gross income ...means...any taxpayer, in any period of assessment...the total amount, in cash or otherwise, received...or accrued...during such year of assessment from a source within or deemed to be within the Republic, excluding receipts or accruals of a capital nature...'

The term 'source' is not defined in the Income Tax Act. To determine the actual source of income a case by case, factual approach is to be followed as the courts have indicated.⁴⁸ In *CIR v Lever Bros and Unilever Ltd*⁴⁹ the court stated that in order to determine the source of income, the originating cause of the income and location of the originating cause must be determined. The source of the income is where the originating cause is located. In *CIR v Black*⁵⁰ it was held that where the income had multiple originating causes, the dominant cause of the income arising must be determined. Therefore, the source of the income will be where the dominant source of the income is located.⁵¹ In determining the originating cause of income the courts looked at two fundamental causes; the employment of capital, and activities. The employment of capital cause was formulated in *COT v William Dunn and Co. Ltd*⁵² and has been applied in conjunction with a 'place of business', as the capital of a taxpayer is often employed where the person's business is carried on.⁵³ The place where the business is carried on

⁴⁸ *CIR v Lever Bros and Unilever Ltd* 1946 (14) SA 250 (A).

⁴⁹ *Ibid.*

⁵⁰ 1957 (3) SA 586 (A).

⁵¹ Buys (2000) 250.

⁵² 1918 AD 301. This test was applied in *M Ltd v COT* 1958 (3) SA 18 (SR); *Overseas Trust Corporation v CIR* 1926 AD 444; *Rhodesia Metals Ltd v COT* 1940 AD 432; *CIR v Black* 1957 (3) SA 586 (A).

⁵³ Buys (2000) 250.

has been expressed in other ways, e.g. the place where contracts are concluded⁵⁴ and the place where control is exercised.⁵⁵

Will this cause be effective to determine the source of sales income of a non-resident vendor that sells goods in South Africa through a web site? Du Plessis and Viljoen have stated that if a person sold the goods through a conventional shop in South Africa there would be a direct link between the capital employed by the foreign entity in South Africa (i.e. the shop, its stock, fixed assets and physical business activities carried on) and the resultant income.⁵⁶ It would therefore, be likely that the originating cause of the sales income would be the shop (capital employed) and business carried on in South Africa. As the capital would be employed in South Africa, the source of the income would also be South African. As such the income would be subject to tax in South Africa.⁵⁷ Du Plessis and Viljoen further state that where a vendor sells goods via a web site, no physical presence will be required in South Africa.⁵⁸ The vendor will generally not employ any significant capital in South Africa: as it has 'virtual' business premises. It is therefore doubtful whether the employment of capital test as applied by the courts will render the e-commerce vendor's income from sales in South Africa, to be from a South African source.

The location of activities cause was formulated in the case of *CIR v Lever Bros and Unilever Ltd*⁵⁹ where the court stated that the originating cause of income was the work

⁵⁴ *Lovell & Christmas Ltd v COT* [1908] AC 609.

⁵⁵ *Overseas Trust Corporation v CIR supra*.

⁵⁶ *Buys* (2000) 250.

⁵⁷ *Ibid*.

⁵⁸ *Ibid*.

⁵⁹ *Supra*. This test was applied in *CIR v Epstein* 1954 (3) SA 689 (A).

that the taxpayer did to earn the income. The work would be the carrying on of a business, an enterprise undertaken, or any activity.

With regard to the capital employment test above it is unlikely that any vendor or person who renders services through a web site or electronically will have to employ any capital in South Africa, as they will not have any physical presence in South Africa.⁶⁰ As regards activities or services in an e-commerce environment, the existing application of tax precedent is similarly challenged. It is further submitted that the place where a person applies his skills and the place where the recipient of the services benefits from these services is not necessarily the same.⁶¹ If the originating cause is where the person who renders the services applies his skills,⁶² the source of income from the services rendered electronically by foreigners in South Africa will be outside South Africa. If the originating cause is where the recipient benefits from the service, the test can still be effectively used for electronic or Internet services. Based on existing case law it is doubtful whether the activities test would be sufficient in taxing services rendered electronically.⁶³

Looking at the potential impact of e-commerce on these two source tests, it is clear why South Africa's tax base has changed from a sourced-based tax system to a residence-based tax system.

The source-based tax system has inadequacies in the e-commerce environment. The reasons for the inadequacies are:

⁶⁰ Buys (2000) 251.

⁶¹ Ibid.

⁶² See *Millin v CIR* 1927 AD 207.

⁶³ Buys (2000) 252.

- The true source of the income has been obscured as the elements of a transaction can be performed in many jurisdictions, thus becoming difficult to determine source and dominant source under South African case law.⁶⁴
- It has become easier and more economically feasible to transfer valued added elements of businesses, which account for a significant portion of the profits of the enterprise, out of the source jurisdiction.⁶⁵

In this regard, it is interesting to note the viewpoints of the United States Department of Treasury and the Australian Taxation Office as they both speculate on the demise of the source basis of taxation, and suggest that the advent of e-commerce will accelerate a trend towards preferring residence-based taxation to source-based taxation. The United States Department of Treasury takes the following view:

'The growth of new communication technologies and electronic commerce will likely require that principles of residence-based taxation assume even greater importance. In the world of cyberspace, it is often difficult, if not impossible to apply traditional source concepts to link an item of income with a specific geographical location. Therefore, source-based taxation could lose its rationale and be rendered obsolete by electronic commerce. By contrast, almost all taxpayers are resident somewhere....'⁶⁶

However, certain commentators have questioned the United States' preference for residency concepts over source concepts.⁶⁷ In their view, the United States is predominantly an exporter of goods and services and will benefit from a taxation system

⁶⁴ CIR v Black supra.

⁶⁵ Buys (2000) 234.

⁶⁶ United States Department of Treasury (1996) para 7.1.5.

⁶⁷ Joint Committee of Public Accounts and Audit (1998) 3. See also Reuve S. Avi-Yonah 'International Taxation of Electronic Commerce' (1997) 52 *Tax Law Review* 525, where the author suggests that the general adoption of a residence-based regime for electronic commerce could raise as many problems as it resolves.

based on residency concepts. It has been suggested that the United States policy 'primarily seeks to protect the interests of American companies and United States revenue.'⁶⁸

In a similar vein the Australian Taxation Office, takes the following view:

'The Internet provides an environment where automated functions, by their very nature, may be able to undertake a significant amount of business activity in a source jurisdiction with little or no physical activity or participation in the economic life in any jurisdiction anywhere. This highlights the inappropriateness in an Internet environment of allocating taxing rights on a concept based on geographical fixedness.'⁶⁹

and further states:

'Australia's source rules are challenged by electronic commerce. Universal access to a web site, automation, and high mobility mean that most electronic commerce activities may generate considerable revenue without necessarily being located in close proximity to the market and without significant use of any infrastructure anywhere. For highly mobile activities (e.g. high value services), source rules are based on location that are more likely to facilitate tax planning. The need to apply source rules to different types of income on a case by case, factual approach will create considerable difficulties in an Internet environment with a large number and variety of interfaces, activities, and modes of delivery.'⁷⁰

The Organisation for Economic Co-operation and Development also identifies source rules as a general problem area:

'The Internet is expected to pose challenges to the operation of the domestic source rules of all member countries. The ability of members to apply domestic source rules to Internet businesses could become crucial if most Internet businesses eventually migrated to low

⁶⁸ Ibid.

⁶⁹ Australian Taxation Office (1999) para 7.2.17.

⁷⁰ Ibid paras 7.2.9. and 7.2.10.

tax jurisdictions, which are generally expected to fall outside tax treaty networks. Potential jurisdictional and enforcement issues for source rules will be common to all OECD members and are likely to benefit from a co-ordinated approach.⁷¹

On the other hand, Professor Vogel has explored a system of taxation based exclusively on source.⁷² This view is based on the concept that it is the 'place of income-generating activity' rather than the jurisdiction where the income producer resides that economically contributes to the production of income and should be compensated for that contribution.⁷³ Focusing on where income-generating activity takes place offers a better chance for international taxing authorities to collect appropriate revenues and avoid double taxation on entrepreneurs. For this standard to work efficiently there would have to be an international understanding of how source is determined. From a perspective of source countries, switching to such proposed source-based system may allow taxing authority over income generated by electronic commerce that arises in the source country but is not generated through a permanent establishment.⁷⁴ Thus, this treatment may prove attractive to countries which are more likely to provide markets for e-commerce goods and services than residences for the businesses themselves.⁷⁵

Judging from the above quotes, source as a basis for taxation will come under pressure. A move away from a source-based tax system to a residence-based system will ensure an efficient system of taxing e-commerce, especially for income from services and

⁷¹ OECD (1998) para 119.

⁷² Doernberg, Hinnekens, Hellerstein & Li (2001) 346. See also Vogel 'Worldwide v Source Taxation of Income – A Review and Re-evaluation of arguments' (1998) 216 *Intertax* 8-9.

⁷³ *Ibid.*

⁷⁴ *Ibid.*

⁷⁵ Craig (2001) 134.

digitised goods. Although the residence-based tax system is better equipped to deal with e-commerce, however, it is still vulnerable to e-commerce.

In South Africa, the basis of the income tax system has shifted from the source of income as the determining factor for tax purposes, to the residency of the taxpayer under the Revenue Laws Amendment Act.⁷⁶ Therefore, the definition of 'gross income' in terms of the Income Tax Act changes as follows, in relation to any year or period of assessment, as:

- 1) in the case of any resident (as defined), the total amount, in cash or otherwise, received by or accrued to or in favour of such resident;
- 2) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within or deemed to be within the Republic.⁷⁷

Thus, with effect from 1 January 2001, South African residents will be taxed on all income, regardless of where it is earned. The effect of the legislation is that a South African resident is taxable on all his receipts and accruals of income (interest, royalties, foreign dividends rental income, annuities, trading income) whether from a South African source or from any other source – in other words, on their world-wide income and non-residents are taxed on income which has its source in South Africa.⁷⁸ One of the important reasons for changing to the new basis of taxation is to more effectively cater for the taxation of e-commerce products, services, and initiatives.⁷⁹ This indeed represents a major tax policy change in South Africa and in many respects pre-empts any such policy recommendations that might have arisen from the e-commerce debate and equips South Africa to deal with the impact of e-commerce more effectively.

⁷⁶ Act 59 of 2000.

⁷⁷ Section 2(c) of the Revenue Laws Amendment Act 59 of 2000.

⁷⁸ See para (i) of the definition of gross income in s 1 of the Income Tax Act 58 of 1962.

⁷⁹ Minister of Finances' speech of 23 February 2000.

However, residence-based taxation raises questions of international tax equity. The residence-based tax framework favours developed countries at the expense of developing countries. Developing countries largely are capital-importing countries.⁸⁰ For a developing country, this means its citizens and companies tend to buy from foreign countries more than foreign countries buy from its citizens and companies. With source-based taxation, a developing country may benefit when foreign companies profit on its soil because it can apply permanent establishment principles and tax that profit. Residence-based taxation, on the other hand, creates an imbalance between wealthier, developed countries (which tend to be capital exporting) and poorer developing countries.⁸¹ 'Under a residence-based taxing regime ...the treasuries of capital importing countries remain poor since these countries cannot collect tax revenue from foreign investment.'⁸² If source income arising from e-commerce were excluded from taxation, developing nations would be put at a disadvantage.⁸³ Instead of being able to tax income from foreign companies that do business within their borders, these developing (source) countries instead would have to watch all their international e-commerce tax revenue instead go directly to the country of residence. Therefore, developing countries stand to lose tax revenue from e-commerce transactions involving foreign countries and this loss will likely grow as times goes on, because as the access to the Internet becomes more universal and the capacity grows, the need for companies to have an authorised human agent will become increasingly less important.⁸⁴ Therefore, the residence-based tax

⁸⁰ Thorpe (1997) 39.

⁸¹ Frost (1997) 1455-1469. See also Hellerstein (2002) 17 where Charles McLure and David Tillinghast have expressed similar views.

⁸² Schaefer (1999) 136.

⁸³ Ibid.

⁸⁴ Ibid 139.

policy for e-commerce is a tax policy that discriminates against the growth of both e-commerce and the social growth of developing countries.⁸⁵

Although it appears that residence-based tax systems would be more suited in an e-commerce environment, as can be seen from the above they are not without difficulties and complexities. Communications technology also affects residence tests under domestic tax laws and under double tax treaties, to the extent that reliance is placed on the location of management functions to determine a taxpayer's residence.⁸⁶ The tests affected are the 'place of effective management' or 'central management and control' and the so-called tie-breaker test contained in many double tax agreements.

In this regard, the Australian Taxation Office warns that:

'The instantaneous and global facilities provided by the Internet are expected to allow residents to more easily influence the operations of their offshore subsidiaries (which would include tax haven entities). There is no clear guidance as to where such a business would be regarded as being carried on. Moreover, there would be difficulties in applying the concept of central management and control. The possibility of undetectable, anonymous or unverifiable nature of these communications could make it even more difficult for the ATO to obtain evidence of these activities should a taxpayer wish to conceal or disguise them.'⁸⁷

In response to the Australian Taxation Office Du Plessis and Viljoen stated:

'Even if guidelines were laid down in domestic law to determine where a company is managed and controlled, due to technological advances it will in principle still be easier for taxpayers to migrate or move their places of residence than is the case at present.

The highly mobile nature of e-commerce and ability of residents to establish offshore

⁸⁵ Ibid.

⁸⁶ Buys (2000) 238.

⁸⁷ Australian Taxation Office (1999) para 7.2.21.

non-resident companies could lead to a tax-driven migration of businesses to low tax jurisdictions, as the case in source-based systems. It will also be possible for a person to be more involved in the management of the operations of a business in a specific country, without necessarily having tax residence in that country. This will place greater importance on the role of controlled foreign corporation measures and their current effectiveness in addressing e-commerce transactions. Even if residence rules and controlled foreign corporation measures prove to be capable of adequately dealing with e-commerce, potential for complete anonymity for Internet users could facilitate widespread offshore or domestic economic activity that cannot be traced back to users.⁸⁸

4.1.3 Residency of Individuals

The residency status of the board of directors of a company influences the 'physical presence' of that company. By establishing the residency status of an individual holding the office of director, taxing authorities are able to determine the physical presence of corporate entities. It is therefore imperative that a discussion on the residency of individuals is conducted.

The definition of residence for individuals is tested by the ability to telecommute. Individuals can more easily avoid numerical residency rules based on a period of physical presence by absenting themselves from a jurisdiction for the necessary number of days while still maintaining employment through telecommuting. For an individual, two alternative tests⁸⁹ are applicable to determine whether or not a person is a resident of South Africa, viz the ordinarily resident test⁹⁰ and the physical presence test.⁹¹ There is

⁸⁸ Buys (2000) 238.

⁸⁹ Paragraph (a) of the definition of 'resident' in s 1 of the Income Tax Act.

⁹⁰ The concept of 'ordinarily resident' test is dealt with in the South African Revenue Services Interpretation Note No. 3 dated 4 February 2002.

no definition of the concept 'ordinarily resident' in the Income Tax Act but it has been a part of South African tax law for many years. The South African Revenue Services Interpretation Note⁹² emphasises that although the Income Tax Act does not define 'ordinarily resident', the courts have interpreted the concept to mean the country to which a person would naturally and as a matter of course return from his wanderings. It would therefore be referred to as a person's usual or principal residence and it would be described more aptly, in comparison to other countries as the person's real home. This approach was followed in *Cohen v CIR*⁹³ and confirmed in *CIR v Kuttel*.⁹⁴ In ascribing, a meaning to the concept 'ordinarily resident' the courts refers it to:

- Living in a place with some degree of continuity, apart from accidental or temporary absence. If it is a part of a person's ordinary regular course of life to live in a particular place with a degree of permanence, he must be regarded as ordinarily resident.⁹⁵
- The place where his permanent place of abode was, where his belongings were stored, which he left from temporary absences and to which he regularly returned after such absences.⁹⁶
- The residence must be settled and certain and not temporary and casual.⁹⁷
- A person is ordinarily resident where he normally resides, apart from temporary or occasional absences.⁹⁸

⁹¹ The 'physical presence' test is dealt with in the South African Revenue Services Interpretation Note No. 4 dated 4 February 2002.

⁹² SARS Interpretation Note No 3 (2002) para 2.

⁹³ 1946 AD 174.

⁹⁴ 1992 (3) SA 242 (A).

⁹⁵ *Levene v Inland Revenue Commissioner* [1928] ALL ER rep. 746 (HL).

⁹⁶ *H v COT* 24 SATC 738.

⁹⁷ *Soldier v COT* 1943 SR.

⁹⁸ *CIR v Kuttel supra*.

If a natural person is not ordinarily resident in the Republic of South Africa, the physical presence test is applied to determine whether he is resident in the Republic for the purposes of the Income Tax Act. The application of the physical presence test must be undertaken annually and consists of three requirements. These are that the person must be physically present in the Republic for a period or periods exceeding:

- i. 91 days in aggregate during the year of assessment under consideration;
- ii. 91 days in aggregate during each of the three years of assessment preceding the year of assessment under consideration; and
- iii. 549 days in aggregate during the three preceding years of assessment.⁹⁹

Some countries rely on a 'bright line' test, which emphasises the physical presence of a person, often for 183 days,¹⁰⁰ and presume that a person is a taxable resident for that year. Strict recording of border-crossings must enforce these physical presence tests, in order to identify that person as a resident of a country. The reason behind using physical location as an identifier of residency is the assumption that a nexus exists between where a person spends their time and what jurisdiction can assert the best claim on that person's income¹⁰¹. These tests have met with substantial criticism because they are arbitrary and easily circumvented by sophisticated individuals.¹⁰² In the context of the Internet, the 183-day test becomes untenable. The geographic location of a person has been of historical importance in affecting where that person is a resident. However, physical location becomes almost meaningless on the Internet when technology exists that enables an individual to carry out activities in another jurisdiction while never

⁹⁹The application is dealt with in the South African Revenue Services Interpretation Note No. 4, dated 4 February 2002.

¹⁰⁰ Typically in the United Kingdom.

¹⁰¹ Sher (2000) 184.

¹⁰² Muscovitch (1996) 13.

actually physically leaving his geographic location even for a single day.¹⁰³ A person effectively makes thousands of 'trips' annually by means of the information highway to another jurisdiction, without ever being subject to border control mechanisms.¹⁰⁴ Since technology enables individuals to carry out transactions in another jurisdiction whilst never actually physically moving, it has been submitted by Craig¹⁰⁵ that a fact and circumstances' approach be used which would assist in this area and has been used in similar cross-border cases involving Canada and the United States.¹⁰⁶

4.1.4 Residency of Companies

With the development of wireless technologies, companies require minimum or no physical presence to conduct business activities. Thus, e-commerce challenges residence taxation by making it easier for companies to be located in low tax or non-tax jurisdictions. In the world of Internet communications, a company may for all practical purposes only exist in cyberspace. Business can be conducted electronically with directors meetings by way of distance communication (e.g. Internet, telephone and video-conferencing). E-commerce indeed creates complexities for the taxation of companies. The following section focuses on whether the existing rules relating to the residence of companies are still appropriate in the digital economy.

There are two basic approaches to corporate residence. Some countries,¹⁰⁷ such as the United States, determine residence by looking at where a corporation is incorporated.¹⁰⁸

¹⁰³ Sher (2000) 184.

¹⁰⁴ Ibid.

¹⁰⁵ Craig (2001) 16.

¹⁰⁶ R & L Food Distributors Ltd v MNR, (1997) CTC 2579.

¹⁰⁷ The Netherlands looks at the 'circumstances' of a company which might include factors such as the location of board meetings, the location of the main office building, or the place where the books are kept.

¹⁰⁸ United States I.R.C § 7701(a)(4).

This is an artificial approach, since incorporation is usually an administrative act and often does not require that the company have any presence in that jurisdiction. However, this approach provides objective certainty.¹⁰⁹

The other approach used in determining residence of companies is the 'place of central management and control' or 'place of effective management', which focuses on determining the jurisdiction where corporate decisions are made.

4.1.4.1 'Central Management and Control'

'Central management and control' is one of the residence tests adopted in a number of countries¹¹⁰ for non-individuals. While determining the 'place of central management and control' is a question of fact, it ordinarily coincides with the place where the directors of the company exercise their power and authority.¹¹¹ A leading case reinforcing this is *De Beers Consolidated Gold Mines Ltd v Howe (Surveyor of Taxes)*,¹¹² in which a company registered in South Africa which worked on diamonds mines, had its head office and held its general meetings of shareholders in South Africa. Its directors held meetings in South Africa and the United Kingdom. The directors' meetings held in United Kingdom were found to be where the real control of the company was exercised. Therefore, the company was found to be a United Kingdom resident. The House of Lords stated that:

'in applying the conception to residence of a company, we ought...to proceed as nearly as we can upon the analogy of an individual. A company cannot eat or sleep but it can

¹⁰⁹ Doernberg, Hinnekens, Hellerstein & Li (2001) 302.

¹¹⁰ For example Australia, Ireland and the United Kingdom.

¹¹¹ *Waterloo Pastoral Co Ltd v FCT* (1946) 72 CLR 262, *Capitol Life Insurance Co v R* (1984) CTC 141 and *Guards Products v R* (1985) CTC 85.

¹¹² [1906] AC 455.

keep house and do business. We ought therefore to see where it really keeps house and does business.’¹¹³

In the Canadian cases of *Birmount Holdings v R*,¹¹⁴ *Tara Exploration and development Co Ltd v MNR*¹¹⁵ and *Capitol Insurance Co v R*¹¹⁶ confirmation was found in the statement of Lord Chancellor in the *De Beers* case where the place of central management and control was where the company ‘really keeps house and does business.’¹¹⁷

These are some factors that can be taken into account in determining the place of management and control. However, these are not conclusive.

- Place of incorporation;
- Place of residence of shareholders and directors;
- Where the business operations take place;
- Where financial dealings of the company occur;
- Where the seal and minute books of the company are kept.¹¹⁸

The court held in *Malayan Shipping Co Ltd v FC* that the company was a resident of Australia because the managing director exercised from Australia complete management and control over the business operations of the company, notwithstanding those trading operations were conducted abroad.¹¹⁹

¹¹³ *Ibid* 458.

¹¹⁴ (1978) CTC 358.

¹¹⁵ (1970) CTC 557.

¹¹⁶ (1948) CTC 141.

¹¹⁷ *Supra*.

¹¹⁸ OECD *The Impact of the Communications Revolution on the Application of Place of Effective Management* (2001) para 21.

¹¹⁹ (1946) 71 CLR 156.

As a result of communicating devices such as videoconferencing and other electronic discussion groups that can be conducted over the Internet the place of central management and control can be difficult to monitor. Due to the borderless nature of e-commerce, moving the location of a business can mean electronically transferring files to a new computer and the ability to incorporate a business in Country X, while half of the directors reside in each of country Y and Z, places a limit on the effectiveness of this test.

4.1.4.2 'Place of Effective Management'

The meaning of the term 'place of effective management' is not defined in the Income Tax Act nor in Article 4 of the OECD Model Tax Convention.¹²⁰ However, the new paragraph 24 in the Commentary on Article 4, which was included in the 2000 update to the Model, offers some guidance on the meaning of the term.

The 'place of effective management' is the place where:

- Key management and commercial decisions that are necessary for the conduct of the enterprise's business are in substance made;
- The most senior person or groups of persons (for example a board of directors) makes its decisions relating to the management of the company (for example high level decision making);
- The center of top level management is located;
- The business operations are actually conducted;
- Legal factors such as the place of incorporation, the location of the registered office, public officer, where the controlling shareholders make key management and commercial decisions in the relation to the company;

¹²⁰ OECD Model Tax Treaty (2003).

- The actions to be taken by the enterprise as a whole are determined;
- The directors reside.¹²¹

However, there is no definite rule that can be given and all relevant facts and circumstances must be taken into account to determine the place of effective management. In the absence of any specific definition of the 'place of effective management', many commentators have been influenced by concepts used in domestic tax law residence rules, such as 'central management and control'¹²² and 'place of management', when considering the meaning of the term 'place of effective management'.

With the borderless nature of e-commerce, it is quite easy for a company to have effective tax residence in more than one country, and as a result, there can be ambiguity as to which country has primary jurisdiction in the taxation of the company's profits.

4.1.4.3 Place of Effective Management in Multi-Jurisdictions

The application of the above factors may not result in a clear determination of residence in the world of cyberspace. With video conferencing and electronic group applications via the Internet, it is no longer necessary for a group of persons to be located or meet in one place to hold discussions and make decisions. If senior managers adopt conferencing through the Internet as a key medium for making management and commercial decisions and those managers are located throughout the world, it may be difficult to determine a place of effective management. A place of management might be regarded as existing in each jurisdiction where a manager is located at the time of making

¹²¹ OECD The Impact of the Communications Revolution on the Application of Place of Effective Management (20001) para 31.

¹²² Australian Taxation Office (1999) para 6.14.

decisions, but it maybe difficult to point to any particular location as being the one place of effective management. However, German case law suggests that the residence of a company may be determined by the residence of the top manager. Therefore, the place of effective management test fails to provide a clear allocation of residence to one country; thus resulting in an ineffective rule.¹²³

The Technical Advisory Group to the OECD has stated the following options to be considered to produce a single residence.

- A. Replace the place of effective management concept;
- B. Refine the place of effective management test;
- C. Establish a hierarchy of tests, as in the individual tie-breaker so that if one test does not provide an outcome, the next test will apply;
- D. A combination of B and C above.¹²⁴

Each will be examined in turn.

A. Replace the place of effective management concept

Various options have been raised to replace the place of effective management concept; such as¹²⁵:

1. Place of incorporation;
 2. Place where directors/shareholders reside;
 3. The place where the economic nexus is strongest.
- The place of incorporation

¹²³OECD The Impact of the Communications Revolution on the Application of Place of Effective Management (2001) para 41.

¹²⁴ Ibid para 48

¹²⁵ Ibid para 50.

The place of incorporation is the place where corporate law applies to the establishment of the enterprise. While the place of incorporation test has the advantage of being easily understood, and has minimal administration and compliance costs, there are nevertheless arguments against its adoption as a test for single residency. The place of incorporation test was rejected as a test in paragraph 22 of the Commentary on Article 4, as 'it would be an inadequate solution to attach importance to a purely formal criterion like registration ...'.¹²⁶ In the e-commerce environment the act of incorporating an enterprise is relatively simple, as many jurisdictions allow online incorporation or establishment resulting in a formalistic tie, i.e. it is only incorporated or established in that jurisdiction. The place of incorporation test is a formal one; therefore, it is possible to change the place of incorporation to another country, by creating a new entity and transferring the business to it or by re-registering in another country. However, in some jurisdictions it may be possible for a company to be incorporated in more than one country, which would render such a test ineffective.

- Place where the directors reside

A test relying solely on where directors or senior managers or shareholders reside will not always give a clear result, as shareholders may not be natural persons.

- Where the economic nexus is strongest

This test may discriminate against multinational enterprises resident in smaller countries, and may be overly difficult to apply as it could involve subjective comparisons.

B. Refine the place of effective management test

¹²⁶ Ibid para 52.

In refining the existing place of effective management test, two options have been suggested.¹²⁷ Either, making a determination on the basis of predominant factor(s) or giving weight to various factors. Paragraph 24 of the 2000 Commentary presupposes that the determination is on the basis of the following predominant factors:

- Where the key management and commercial decisions are made in substance;
- Where the most senior person or group of persons makes its decisions and where the actions are to be taken by the enterprise.¹²⁸

However, where analysis of these predominant factors does not produce a single place of effective management, it may be necessary to consider other additional factors, as is suggested in paragraph 21 of the commentary¹²⁹ where it states that 'however, no definitive rule can be given and all the relevant facts and circumstances must be examined to determine the place of effective management.' Others factors which may be considered in association with the dominant factors could include:

- Location of and functions performed at the headquarters;
- Information on where central management and control of the company is to be located contained within company formation documents (articles of association);
- Where the majority of directors reside.

In May 2003, the TAG has issued a draft document¹³⁰ expanding the Commentary explanations as to how the concept should be interpreted. The TAG stated that where the key management and commercial decisions necessary for the conduct of the entity's business are in substance made in one place by a person but are formally finalised

¹²⁷ Ibid para 62.

¹²⁸ OECD Model Tax Treaty (2003).

¹²⁹ OECD The Impact of the Communications Revolution on the Application of Place of Effective Management (2001) para 52.

¹³⁰ OECD Place of Effective Management Concept (2003) para 5.

somewhere else by it or by a another person, it is necessary to consider the following factors¹³¹:

- Where a board of directors formally finalises key management and commercial decisions necessary for the conduct of the entity's business at meetings held in one country but these decisions are in substance made in another country, the place of effective management will be in the latter country;
- If there is a person such as a controlling interest holder (e.g. a parent company) that effectively makes the key management and commercial decisions that are necessary for the conduct of the entity's business, the place of effective management will be where that person makes these key decisions (the key decisions made by that person must go beyond decisions related to the normal management and policy formulation of a group's activities);
- Where a board of directors routinely approves the commercial and strategic decisions made by the executive officers, the place where the executive officers perform their functions would be important in determining the place of effective management of the entity.

C. Establish a hierarchy of tests, as in the individual tie-breaker so that if one test does not provide an outcome, the next test will apply

Article 4 paragraph 2 of Model Tax Convention establishes a hierarchical approach for individual residency tie-breaker. Thus, a similar approach may be adopted for companies. According to the Committee a possible structure for such a hierarchy may be¹³²:

- place of effective management;

¹³¹ Ibid para 7.

¹³² Ibid para 71.

- place of incorporation;
- economic nexus;
- mutual agreement.

D. A combination of options B and C.

While some of these options may prove to be an ineffective option in isolation, they may be effective when combined with the other options. In the discussion document the OECD has stated the following options to be used as a possible structure if the place of effective management cannot be determined¹³³:

1. the place with which its economic relations are closer;
2. the place in which its business activities are primarily carried on;
3. the place in which its senior executive decisions are primarily taken.

Clearly, e-commerce weakens the 'place of effective management' test because management decisions may occur during online conference between corporate heads in various taxing jurisdictions. For this reason, it is argued that a modified form of the 'place of effective management' test should be applied with regard to e-commerce transactions. Instead of simply looking at one factor, such as the place of incorporation or the place where decisions are made, all jurisdictions the company has economic connections should be examined and the place where the entity has the most ties should be considered its country of residence. While it might be easy to switch the location of directors meetings, it would require a tremendous effort to move the bulk of a company's physical presence and business activities to a more favourable taxing jurisdiction.

¹³³ OECD Place of Effective Management Concept (2003) para 8.

4.1.5 Residence of Partnerships and Trusts

The question of the residence of partnerships and trusts is closely intertwined with the legal status of these entities. The Income Tax Act defines the term 'person' as including a trust.¹³⁴ A partnership in South Africa is not a separate legal persona distinct from the partners,¹³⁵ nor is it recognised by the Income Tax Act as a distinct taxable entity. In general, where these entities are regarded as separate taxable entities, their residence is determined in a manner closely analogous to that of companies,¹³⁶ as discussed above. Therefore, the residence of partnerships and trusts would pose the similar difficulties and challenges as that of a company with regard to e-commerce.

4.1.5 Conclusion

Following from the preceding discussion, clearly, both the concepts of source and residence are equally at risk in an e-commerce environment and neither provides a conclusive solution to the challenges created by e-commerce. Electronic commerce poses a threat to source country taxation by blurring the character of income and making traditional source rules meaningless in many cases. For transactions taking place over the Internet it has become increasingly difficult to determine where the source of income is earned, actually is. The result is that innovative taxpayers, through complex avoidance and evasion schemes, can decrease the amount of tax paid and threaten the stability of economies by manipulating the tax base. Traditional residence concepts are based on 'physical presence', which becomes almost impossible to determine in the digital economy. Trading over the Internet facilitates the ability of corporate entities to function without a consistent physical presence in any single jurisdiction. Furthermore, the use of video conferencing and the overall improvements in communications technology allow

¹³⁴ See s 1 read with s 25B of the Income Tax Act 58 of 1962.

¹³⁵ See *R v Levy* 1929 AD 312.

¹³⁶ Macheli (2000) 43.

management to reside in different jurisdictions and still coordinate decision making. The result is that determining the residence of a judicial entity such as a company becomes an even more artificial exercise than it has ever been. It has already been tested that the traditional principles of tax do not provide a miracle solution to electronic commerce. Both the concepts of source and residence need to be re-examined to take into account trading on the Internet. It is submitted that further research and consultation is required by taxing authorities, and a fine tuning of the traditional concepts, drawing on the strengths of both source and residence principles, be considered thus creating a more comprehensive tax net to cater for e-commerce.

4.2 Double Tax Agreements

International double taxation can be defined as the 'imposition of comparables taxes in two (or more) States on the same taxation in respect of the same subject matter and for identical periods.'¹³⁷ It occurs when one foreign jurisdiction taxes income without checking to see if it might have already been taxed by another tax jurisdiction.¹³⁸ Most countries have developed means of mitigating this harsh result, either through their own individual tax codes (exemption method),¹³⁹ or through their bilateral or multilateral tax treaties with other countries.¹⁴⁰ A country will usually have a separate tax treaty for each country with which it desires to enter into relations, each containing slightly different terms.¹⁴¹ However, as a general rule, most current international treaties give the

¹³⁷ Thorpe (1997) 41; OECD Double Tax Convention on Income and on Capital (1977). See also s 108(1) of the Income Tax Act 58 of 1962.

¹³⁸ Ibid.

¹³⁹ This practice is far less common and involves the country of residence of the business enterprise exempting from tax profits which arise outside its jurisdiction.

¹⁴⁰ This is known as the credit method and involves the business enterprises country of residence giving relief for overseas taxes suffered by offset (credit) of the foreign tax against the corresponding domestic liability.

¹⁴¹ For example, the United States currently has comprehensive income tax treaties with 48 countries.

residence country an unlimited right to impose tax on the worldwide profits of resident companies, and limit or eliminate the source country's right to tax.¹⁴² Non-resident companies may only be taxed in those profits, which arise from a source within the non-resident country's jurisdiction.¹⁴³ To avoid double taxation in a situation where an enterprise is resident in one country with income originating in another, most tax treaties provide that for profits to qualify as having arisen in the source country, they must have been earned through a permanent establishment created by the non-resident company in that jurisdiction.¹⁴⁴ If no permanent establishment is found, the source country may tax the profits.¹⁴⁵ Thus, the capability to tax profits from electronic commerce rests on an ability to find that an enterprise conducting business over the Internet either has a place of residence in a given jurisdiction, or derived its profits from business carried on within a designated country where it has a permanent establishment, or both.¹⁴⁶ An analysis of typical electronic commerce activities demonstrates the difficulty of actually applying such rules to the Internet. The main problem with taxing electronic commerce stems from the general configuration of the Internet. For example, placing a store anywhere on the Internet makes it present, in effect, everywhere. There is no central, worldwide, technical control point,¹⁴⁷ and it is difficult to assign a physical location for taxation purposes to the component parts of an electronic transaction. Users of the Internet have no control over, and usually no specific knowledge of, the part that is traveled by the

¹⁴² United States Department of Treasury (1996) para 7.1.4.

¹⁴³ Thorpe (1997) 41.

¹⁴⁴ The source of the income and finding of a permanent establishment are independent determinations, which the being the key to taxation. The source of income is not sufficient by itself nor a necessary condition in a permanent establishment determination. See Thorpe (1997) 41 and Skaar AA 'Permanent establishment: Erosion of a Tax Treaty Principle' (1991).

¹⁴⁵ Source countries tend to give up their source-based taxing rights over business profits if they are not attributable to a 'permanent establishment' or 'fixed base' in their jurisdiction. United States Department of Treasury (1996) para 7.2.4.

¹⁴⁶ Thorpe (1997) 42.

¹⁴⁷ United States Department of Treasury (1996) para 2.4.

information they seek to publish.¹⁴⁸ This makes it harder for companies doing business in cyberspace to know in which countries they are or not subject to taxation. Not falling within any country's jurisdiction for taxation purposes leaves those using the Internet for commerce purposes open to international double taxation or double non-taxation. Therefore, it is necessary to make decisions regarding whether a server, Internet service provider, user, web page, cables, or terminal satisfies the requirements for residence or permanent establishment. In addition, clarity is needed on the characterisation of income.

It becomes increasingly difficult to apply these concepts in the context of electronic commerce. Double Tax Agreements are vital in transactions of e-commerce as taxpayers may be situated anywhere in the world. In this regard, the Katz Commission drew the following conclusion:

'...it can be reasonably assumed that much of this (electronic commerce) tax evolution will take place through treaty negotiations around concepts like the permanent establishment definition, attribution rules or exemptions or credits affecting passive income.'¹⁴⁹

The United States Department of Treasury identified the role of tax treaties as one of the most substantive issues on the taxation of electronic commerce.¹⁵⁰ Guttentag¹⁵¹ submits that:

¹⁴⁸ Ibid, para 6.3.1.

¹⁴⁹ Katz Commission Report (1998) 7.4.2.

¹⁵⁰ United States Department of Treasury (1996) paras 7.1.4 and 7.2.2.

¹⁵¹ Guttentag is the senior advisor in the Office of Tax Policy at the United States Department of Treasury.

'with the increasing number of cross-border transactions, we are faced with increased problems of double taxation resulting from the differences in tax laws and their administration.'¹⁵²

In Response to Guttentag, Mauro stated that:

'There can also be a problem of no taxation, if the tax laws can result in each of two countries determining that they are entitled to tax a transaction on the grounds that there was a sufficient economic nexus of the transaction to their jurisdiction, then it also follows that the same two countries, with respect to another transaction, could determine that neither should tax. Taxpayers can cross borders solely for the purpose of taking advantage of the lack of uniformity either in tax law or its administration.'¹⁵³

However, the Clinton/Gore administration has placed a high priority on negotiating and renegotiating the double tax agreements with the co-operation of other countries.¹⁵⁴

Therefore, the lack of international consensus on the taxation of e-commerce could result in the double taxation or non-taxation of international electronic transactions and create a prejudice in favour of more conventional forms of commerce, which, if not addressed, may cause uncertainty and an erosion of the tax base.

4.3 Permanent Establishment

One of the most significant provisions included in international double tax treaties is the listing of activities, which lead to a finding that a business operation has a permanent establishment in a given country. However, with the emergence of electronic commerce finding such a taxable activity or presence within a country is often tenuous at best, since there are no business offices in existence anywhere. Thus, the question of permanent

¹⁵² Mauro (2000) 34.

¹⁵³ Ibid.

¹⁵⁴ Ibid.

establishment becomes a pivotal issue with regard to e-commerce. The purpose of this section is to analyse the concept of permanent establishment in the context of e-commerce. To achieve this, the following section discusses how the traditional definition of a permanent establishment applies to electronic commerce, and examines whether this concept needs to be adapted or abandoned.

Permanent establishment is a 'fixed place of business through which the trade of an enterprise is wholly or partly carried on.'¹⁵⁵ The term 'fixed' is broken into two components, 'spatial and temporal.' One refers to a geographical situs within a taxing country, and the other refers to time. Traditionally, a geographical situs means attachment to a geographic location for a significant amount of time¹⁵⁶ i.e. with a certain degree of permanence rather than temporarily. The time component does not require a perpetual nature, but rather refers to indefinitely continuing.

Guidelines on what constitutes a 'fixed place of business' are detailed in Article 5 of the OECD Model Tax Convention. Article 5(2) states that the term 'permanent establishment' includes:

- A place of management;
- A branch;
- An office;
- A factory;
- A workshop; and
- A mine, an oil, or gas well, a quarry or any other place of natural resources.¹⁵⁷

¹⁵⁵ Article 5(1) of the OECD Model Tax Treaty (2003).

¹⁵⁶ Guleman (2001) 3.

¹⁵⁷ Article 5(2) OECD Model Tax Treaty (2003).

This list is not illustrative and non-exclusive.

Activities that are merely of a preparatory or auxiliary nature are excluded from the definition of 'permanent establishment' even if they are carried on through a fixed place of business. However, a permanent establishment does not include the use of facilities for the sole purpose of storing, displaying, or delivering goods or a place used solely for purchasing goods or collecting information.¹⁵⁸

4.3.1 The Adaptation of the Concept of Permanent Establishment to E-commerce

Article 5 of the OECD Model Tax Treaty provides two different manners in which a business can have enough ties to cause a permanent establishment to exist:

- physical permanent establishment: this is a fixed place of business through which the business of the enterprise is wholly or partly carried on;
- agency permanent establishment: this applies to dependent agents exercising their authority to contract.

According to the 'physical permanent establishment' test, a permanent establishment exists only if three basic elements are satisfied:

- 1) a 'place of business' must exist (this includes a facility with a premises, or in some cases machinery);
- 2) the place of business is 'fixed' such that it is established at a distinct place with a certain degree of permanence; and
- 3) there is a 'carrying on' of the business of the enterprise at this fixed place of business.

¹⁵⁸ Article 5(4) of the OECD Model Tax Treaty (2003). See the appendix for a detailed explanation on what constitutes a permanent establishment.

In the traditional non-electronic commerce environment, these three elements are relatively straightforward to apply.¹⁵⁹ In a non-electronic commerce context, the first element of a 'place of business' normally can be applied with the most amount of certainty as most companies that conduct business in foreign countries have some sort of facility or premises in those countries, which act to benefit the country.¹⁶⁰ For e-commerce, however, tax authorities have not readily concluded where the place of business exists,¹⁶¹ since the Internet is not in one location, but rather is a non-centralised network with many different component parts. Therefore, tax authorities have difficulty in pinpointing which part to specifically examine for tax purposes.¹⁶²

Like the first element, the second element, whether a place of business is fixed, produces relatively certain results in a non-electronic commerce forum. The OECD Model Tax Treaty Commentary provides that the place of business must be situated with a certain degree of permanence at a distinct place.¹⁶³ This degree of permanence has been interpreted in many countries to be the duration of six months.¹⁶⁴ In a traditional business forum, most enterprises with businesses in foreign countries have readily identifiable fixed places of businesses in those countries, usually in the form of offices or factories. However, like the first requirement, one strains to apply the components of e-commerce to the existing tax rules. In an e-commerce forum, with a (computer's) server, the second element's purpose is not served because a server's 'fixedness' is immaterial.¹⁶⁵ A server could be 'located on a portable computer used in different places

¹⁵⁹ Schaefer (1999) 125. See also Peschcke-Koedt (1998) § (I) (B) (I).

¹⁶⁰ Ibid.

¹⁶¹ See Frost (1997) 1469.

¹⁶² OECD E-commerce (1998) 97.

¹⁶³ Article 5 of the OECD Model Tax Treaty (2003).

¹⁶⁴ Schaefer (1999) 128. See also Skaar AA 'Skaar Discusses Permanent Establishment Concept' 1997 *Tax Analysts Worldwide Tax Daily* 203-13.

¹⁶⁵ Frost (1997) at 1469.

within (a) building or moved from city to city by an itinerant employee',¹⁶⁶ and perform its function perfectly. Moreover, in order to avoid having a fixed place, a business could easily move its web site information from one server to another.¹⁶⁷ Furthermore, as mentioned above, a place such as a warehouse used for storage, display, or delivery of goods does not constitute a permanent establishment,¹⁶⁸ and if a server just stores and delivers information, it could be considered an electronic warehouse.¹⁶⁹ As a result, it seems highly unlikely a server could be 'fixed' within the meaning of the second element. While entailing a simpler analysis, web sites are also likely to fail the 'fixed' requirement.¹⁷⁰ A web site may only be on a computer screen for a number of seconds or minutes before a transaction takes place, which is at odds with the OECD requirement that the fixed place be 'permanent'. The fact that web sites are not tangible like traditional fixed places, makes it highly unlikely that web sites could be considered fixed.¹⁷¹ The third element necessary to find a permanent establishment requires a 'carrying on' of the business at this fixed place of business. The OECD Model Tax Treaty Commentary sets quite broad guidelines for this, as it states that a 'carrying on' need not even involve humans or decision-making.¹⁷² This means that computers and machines alone can carry on a business activity, as long as genuine business activity such as operation or maintenance is conducted.¹⁷³ A server would likely fail this third element because although maintenance or operation is conducted, it is dependent on the web site for electronic commerce; a server cannot 'carry on' business on its own.¹⁷⁴ Web sites

¹⁶⁶ OECD E-commerce (1998) 97.

¹⁶⁷ Frost (1997) 1450.

¹⁶⁸ Article 5 para 4(a) of the OECD Model Tax Treaty (2003).

¹⁶⁹ United States Department of Treasury (1996) para 7.2.4.

¹⁷⁰ Schaefer (1999) 130.

¹⁷¹ *Ibid.*

¹⁷² *Ibid.*

¹⁷³ *Ibid.*

¹⁷⁴ Schaefer (1999) 130. See also Thorpe (1997) 43.

on the other hand, are likely to fulfill this element, as it exists to conduct business activity.

In conclusion, neither servers nor web sites can reasonably qualify as a fixed place of business, as neither fulfills all three requirements. A sever does not fit well into any of the three requirements, and while a web site may in fact 'carry on' a business activity, problems still remain because a place of business remains unclear and it does not stay fixed for a sufficient period of time.¹⁷⁵

The second manner in which a permanent establish may be found, as described in Article 5 of the OECD Model Tax Treaty is if a company has an agent in a source country. The OECD Model Treaty states that a permanent establishment by agency may be found where¹⁷⁶:

- 1) a dependent agent;
- 2) acts on behalf of an enterprise in a foreign State;
- 3) has an authority to conclude contracts in that foreign State in the name of the enterprise;
- 4) habitually exercises such authority.

These elements are traditionally applied to salespersons that may or may not take trips in and out of a source country.¹⁷⁷ The first element for finding a permanent establishment by agency normally is determined when ascertaining the scope of the agent's job.¹⁷⁸ Essentially, to fulfill this requirement the agent cannot both be self-employed and

¹⁷⁵ Ibid.

¹⁷⁶ Article 5(5) of the OECD Model Tax Treaty (2003).

¹⁷⁷ Schaefer (1999) 132. See also Skaar op cit (fn 162) 4.

¹⁷⁸ Ibid.

perform similar activities for more than one business.¹⁷⁹ This is relatively straightforward as applied to software agents, since the software agent likely would not be self-employed elsewhere and would not perform similar activities for other businesses. As a result, software agents would likely fulfill this first element. The second element, whether the agent acts on behalf of the enterprise, can be difficult to ascertain in the traditional context.¹⁸⁰ The main question here is whether the agent is 'acting for the benefit of the principal.'¹⁸¹ Determining whether a software agent complies with this requirement is a relatively easy task because a software agent is specifically programmed to act for the benefit of the principal. Accordingly, it can be presumed that by carrying out the directions of the principal via a program, the agent acts for the benefit of the principal. If a software agent is deemed to exist at the point of sale, then the third element can be fulfilled. The primary question for the third element is whether the agent 'is acting as intended or reasonably expected by the principal.'¹⁸² Computer agents are more easily applied than human agents to this element because they are specifically programmed to act in a certain manner, so presumably they act as the principal intends or reasonably expects them to act. The fourth element, whether the agent habitually exercises its authority, is primarily a requirement of regularity or frequency¹⁸³ and excludes incidental or sporadic acts.¹⁸⁴ A computer agent should be held to the same standards as a human agent for this element, as their functions and jobs are substantially identical, and as such the software agent should fulfill this element in the same way as a human agent. In conclusion, it appears that under the traditional permanent establishment regime, the first, third, and fourth elements are fulfilled relatively easily. The second element is more

¹⁷⁹ Article 7(1) of the OECD Model Tax Treaty (2003).

¹⁸⁰ Thorpe (1997) 43.

¹⁸¹ Peschoke-koedt (1997) § I(B)(2)(b).

¹⁸² Peschoke-koedt (1997) § I(B)(2)(c).

¹⁸³ Schaefer (1997) 131. See also Skaar op cit (fn 162) 71.

¹⁸⁴ Peschoke-koedt (1997) § I(B)(2)(d).

uncertain, however, it is unclear exactly where a software agent may be deemed to conduct its business.

Therefore, the advent of electronic commerce introduced many challenges to the permanent establishment concept. Professor Hinnekens expresses concern whether 'tomorrow's business may be effectively taxed under the application of yesterday's rules.'¹⁸⁵ As detailed in the above discussion, the application and enforcement of traditional tax principles is more difficult to apply to e-business than in the brick and mortar business world. It is therefore evident that governments throughout the world need to clarify the application of the permanent establishment definition in e-commerce to maintain their fiscal effectiveness.

4.3.2 Clarification on the Application of the Permanent Establishment Definition in E-commerce

The Committee of Fiscal Affairs to the OECD has released clarification on the application of the permanent establishment definition in e-commerce. The views expressed by the Committee will be discussed below. The issues to be addressed are:

- 1) Whether a website alone can constitute a permanent establishment? (Web sites and Servers)
- 2) Whether computer equipment may give rise to a permanent establishment? (Computer Equipment)
- 3) Can the location of an ISP create a permanent establishment? (Internet Service Providers (ISP), Web Sites, and Agency)
- 4) Core Functions

¹⁸⁵ Chetcuti (2002) 9.

- 5) Whether the 'preparatory and auxiliary' exception to permanent establishment apply to transactions in e-commerce, and if so, under what circumstances are the activities considered to be of a preparatory or auxiliary in nature? (Preparatory or Auxiliary)
- 6) Whether a business entity can be found to have a permanent establishment even in the absence of personnel within that country (Human Invention)

4.3.2.1 Computer Equipment

To determine whether computer equipment operated by a company may constitute a permanent establishment in the country where it is situated, a distinction must be made between the computer equipment which may be set up at a location so as to constitute a permanent establishment; and the data and software which is used by or stored on that computer equipment.¹⁸⁶ This distinction is important in that it recognises the traditional notion of a fixed place of business. For example, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a 'place of business' as there is no fixed premises, machinery or equipment. However, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such a physical location may thus constitute a 'fixed place of business' of the enterprise that operates that server.¹⁸⁷

¹⁸⁶ Paragraph 42.2 of the OECD Clarification on the application of the permanent establishment definition in e-commerce.

¹⁸⁷ Ibid.

4.3.2.2 Web sites and Servers

The approved changes to the commentary on Article 5¹⁸⁸ distinguishes between web sites and servers for permanent establishment purposes so that web sites stored on a server should not constitute a permanent establishment. However, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location. Such a location may constitute a 'fixed place of business' of the enterprise that operates that server as long as the server is fixed at a certain place for a sufficient period of time. The permanence test looks at whether the server has actually been moved, irrespective of whether it can or cannot be moved. Therefore, computer equipment at a given location may constitute a permanent establishment if it meets the requirements of being fixed.¹⁸⁹

For a server to constitute a permanent establishment, it would have to meet the following requirements¹⁹⁰:

- The server on which the web site is hosted and its location have to be at the foreign enterprise's disposal- owned or leased and operated by the enterprise – not web hosting¹⁹¹
- The server must be located in the taxing country - a 'fixed place of business'
- Core business activities have to be performed through the server, as opposed to preparatory or auxiliary functions, without the need for human intervention.

A distinction is also made between the web site operator and the server operator, who may not be the same person. The former enterprise 'carries on business through the web site' but does not necessarily operate the server. In the case of web hosting

¹⁸⁸ OECD Model Tax Treaty (2003).

¹⁸⁹ OECD Clarification on the Application of the Permanent Establishment Definition in E-commerce (2000) para 42.4.

¹⁹⁰ Ibid.

¹⁹¹ A service provided whereby a client is allocated a certain amount of storage space on a web server to enable a user to upload a web site to that space.

arrangements, the enterprise's web site is hosted on a server operated by an ISP. A permanent establishment may only arise where the server is at the disposal of the online enterprise that owns or leases it, and can never arise in the case of ISP hosting.

The United Kingdom, Germany, and Switzerland have suggested that servers should not be used to create a nexus.¹⁹² The United Kingdom took the position that in no circumstances will a business have a permanent establishment in the United Kingdom simply through owning or leasing a server in the United Kingdom.¹⁹³ On the other hand, Spain and Portugal dissented from the OECD view on the grounds that web sites should not be treated as permanent establishments, as more revenues would be allocated to net e-commerce importing countries through a broader view of the nexus for e-commerce purposes.¹⁹⁴

4.3.2.3 Internet Service Providers (ISP), Web sites, and Agency

The agreements between Internet service providers and businesses or individuals for the use of space on the server will not give rise to a permanent establishment. The reason for this is that an ISP lacks authority to conclude contracts in the name of the business renting space from the ISP.¹⁹⁵ Alternatively, an ISP will not give rise to a permanent establishment because an ISP is ordinarily acting as an independent agent in the ordinary course of its business. An additional question that can be asked is whether the web site itself can be considered an agent of the business and therefore constitute a permanent establishment? Paragraph 42.10 of the OECD commentary answers this

¹⁹² Cockfield (2002) 9.

¹⁹³ United Kingdom Inland Revenue (2000) 41.

¹⁹⁴ Cockfield (2002) 9.

¹⁹⁵ OECD Clarification on the Application of the Permanent Establishment Definition in E-commerce (2000) para 42.10.

question in the negative. Articles 3 and 5 of the OECD Model Tax Convention¹⁹⁶ will lead to the conclusion that a web site cannot be considered an agent of the business. Article 5(5) uses the word 'person' to describe how an agency relationship may give rise to a permanent establishment. Article 3 provides a general definition of the word 'person' as 'an individual, an estate, a trust, a partnership, a company, and any other body of persons.' Therefore, if a web site does not fit into any of these categories, it would not be considered an agent of the business. In the absence of an agency relationship, the web site should not give rise to a permanent establishment.

4.3.2.4 Core Functions

The determination of what constitutes core functions for an enterprise depends upon the nature of the business carried on by that enterprise.¹⁹⁷ This requires that the functions performed at that place be significant as well as an 'essential' or 'core' part of the business activity of the enterprise. Where the server functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment there would be a permanent establishment.

4.3.2.5 Preparatory or Auxiliary

An indicative list of activities generally considered preparatory or auxiliary includes:

- providing a communications link;
- advertising goods or services;
- relaying information through a mirror server;

¹⁹⁶ OECD Model Tax Treaty (2003).

¹⁹⁷ OECD Clarification on the Application of the Permanent Establishment Definition in E-commerce (2000) para 42.9.

- gathering market data or supplying information.¹⁹⁸

Whether these or other activities should be characterised as ‘auxiliary’ or ‘preparatory’ in nature ‘needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment.’¹⁹⁹ Thus, online advertising, the provision of an online catalogue or the provision of online information to prospective customers by an e-tailer²⁰⁰ does not create a permanent establishment. However, an online advertising agency’s online adverts or the online research activities of an online market analyst are likely to constitute core activities and this contributes to establishing a permanent establishment.²⁰¹ Therefore, the core functions performed on the equipment, may give rise to a permanent establishment but only if the equipment constitutes a fixed place of business.

4.3.2.6 Human Intervention

A permanent establishment may exist even in the absence of any human personnel at the ‘fixed’ location. Where personnel are not required to carry on the business in the location in which the equipment is located, their absence does not necessarily mean that a business does not operate wholly or mainly in that jurisdiction²⁰². The OECD further explains that this conclusion applies likewise to e-commerce as it does to other activities where automatic equipment is used. This position supports the German ‘pipeline’ case in which the Second Chamber of the German Supreme Tax Court²⁰³ held that an oil pipeline in Germany, owned by a Dutch company, created a permanent establishment

¹⁹⁸ Ibid.

¹⁹⁹ Ibid.

²⁰⁰ Paragraph 42.9 of the OECD Clarification on the Application of the Permanent Establishment Definition in E-commerce (2000) defines an e-tailer as an enterprise as an enterprise that carries on the business of selling products through the Internet.

²⁰¹ Ibid para 42.7.

²⁰² Ibid para 42.8.

²⁰³ The “Pipeline” case, Bundesfinanzhof (BFH) II R 12/92, Betriebs-Berater, 52 (1997), 138.

despite the absence of employees. The Dutch company supplied oil to German customers through the underground pipeline, which ran through the Netherlands and Germany. The German customers received oil at delivery stations in Germany, which they owned and operated. The Dutch company regulated the flow of oil through the pipeline by remote control from a computer in the Netherlands. The Dutch company had no employees or dependent contractors in Germany. Maintenance and repair on the pipeline in Germany was performed exclusively through independent contractors. The German court defined a permanent establishment as any fixed place of business or assets that serves the business activities of the taxpayer. The court held that the pipeline constituted a fixed place of business in Germany. With respect to the requirement that the pipeline must serve the taxpayer's business, the court stated that a fixed place of business serves a business activity when a taxable person exploits it for a certain period of time for business purposes.

According to Westin,²⁰⁴ this case has two important implications for electronic commerce. First, it shows the willingness of a court to apply the permanent establishment concept expansively to technology that was not anticipated when the permanent establishment concept was adopted. Second, it increases the risk that a telecommunications company or an Internet Service Provider, whose only contact is automated equipment such as telephone lines or a server, has a permanent establishment overseas. By analogy to the pipeline in the case, telephone lines or servers could constitute a fixed place of business through which the main line of an Internet Service Provider or a telecommunications company, namely the transfer of electronic signals, is carried on, thereby constituting a permanent establishment

²⁰⁴ Westin (2000) 353.

wherever the telephone lines or servers are located.²⁰⁵ It is further submitted that this offers other revenue agencies around the world an additional arrow in their quiver with which to tax telecommunications companies and Internet service providers. While the impact of this decision is not clear,²⁰⁶ it seemed obvious that 'prudent tax planning would dictate that servers be located outside Germany'²⁰⁷ if possible, at least until a German authority carved out an exception for servers.²⁰⁸ If the web site operator owned a server in Germany on which its web site was located, it is possible that, based on this decision, the enterprise would have a permanent establishment.²⁰⁹

However, according to Craig²¹⁰ care should be taken to ensure a uniform approach to interpreting permanent establishment as redefined to avoid local anomalies; for example, in the decision of the 'pipeline' case the pipeline crossing Germany but owned by a Dutch company may be deemed to be sufficient to constitute a permanent establishment under German domestic law; this would not be sufficient under the revised OECD model.

4.3.4 Should the Concept of Permanent establishment be abandoned?

The concept of permanent establishment appears to have lost relevance with technological advance in communication and the development of teleconferencing. However, the question arises: should the concept of permanent establishment be abandoned?

²⁰⁵ Ibid.

²⁰⁶ See Hey whereby it is indicated that the location of a server within Germany gives rise to a permanent establishment, and Frost indicates that a human presence is essential to finding a permanent establishment. See also Westin (2000) 353.

²⁰⁷ Ibid.

²⁰⁸ Westin (2000) 353.

²⁰⁹ Ibid, the German tax authorities have since issued a statement that they do not believe that a server alone can constitute a permanent establishment.

²¹⁰ Craig (2001) 27.

The permanent establishment concept has been a mainstay of international tax law for more than 70 years and has shown remarkable resiliency and international acceptance as an international income tax principle. In recent decades, however, the physical presence requirement of the traditional permanent establishment concept has undergone significant modifications to take into account emerging commercial practices, enhanced global trade, and increased mobility of capital. Even before the advent of the Internet, and the rapid development of electronic commerce, it was recognised that there may be significant shortfalls with the operation of the traditional permanent establishment concept in the modern environment.²¹¹ In this regard Professor Skaar, states that:

‘... mobility of business enterprises and the rapid development of modern communication in the world have changed real life more fundamentally than is reflected by the changes in the permanent establishment concept.’²¹²

Notwithstanding the inevitable disputes about what constitutes a permanent establishment, the permanent establishment concept has served the international community well. One of the reasons that explain the permanent establishment's success is the flexibility of the concept. Therefore, many advocate that while the permanent establishment concept is by no means perfect and generates its own interpretation problems, it is the ‘devil we know’ and may be worth preserving. In similar vein, Sprague and Hersey argue that the current system remain appropriate, given the expansive treaty network based on the current permanent establishment rules, and e-commerce's permeation into all facets of current business affairs, designing one set of nexus rules for

²¹¹ Australian Taxation Office (1999) 105-106.

²¹² Thorpe (1997) at 135; see also Skaar *op cit* (fn 162) 571.

e-commerce companies, and another for non-e-commerce companies makes no logical sense and would be practically impossible to implement.²¹³

Others disagree with this approach and argue that it is not a viable option, given the fast growing significance of electronic commerce and the impact of its special characteristics, which was not considered when the current rules for international income taxation were designed. Thus it has been argued that most of the components of electronic commerce do not appear to fit within the existing taxation principles regarding permanent establishment. The Indian Ministry of Finance is of the view that²¹⁴:

'applying the existing principles and rules to e-commerce does not ensure certainty of tax burden and maintenance of the existing equilibrium in sharing of tax revenues between countries of residence and source. The Committee is also firmly of the view that there is no possible liberal interpretation of the existing rules, which can take care of these issues, as suggested by some countries. The Committee, therefore, supports the view that the concept should be abandoned and a serious attempt should be made within the OECD or the UN to find an alternative to the concept of permanent establishment.'

However, Professor McLure posits that basing nexus on physical presence may not make sense in the digital age, and suggests that an 'economic nexus' would be a more appropriate concept.²¹⁵ Cockfield expresses the similar view and argues for further evolution of the permanent establishment principle to take into account modern commercial practices such as e-commerce that permit non-resident companies to generate significant revenues in foreign markets without the need for a physical

²¹³ Sprague & Hersey (2003) 9.

²¹⁴ Cockfield (2002) 11. See Indian Ministry of Finance report of the High Powered Committee on E-commerce and Taxation (2001) 11-12.

²¹⁵ Ibid 3.

presence²¹⁶. He further states that the OECD model tax treaty and the United Nations model tax treaty should possibly incorporate a quantitative economic presence test that enables the source countries to tax above threshold sales despite the absence of any physical presence. This view is further supported by Skaar by suggesting that the 'future is likely to prove that the permanent establishment principles has lost its force for new and mobile industries, whether tax treaties are renegotiated for this purpose or not.'²¹⁷ Alternatively, the economic presence permanent establishment can be portrayed as simply another step in the evolution of the permanent establishment concept as physical presence requirements have already undergone dilution through the developments previously. However, it is recognised that further consideration and analysis would be necessary prior to serious consideration of this possible approach.²¹⁸

On the other hand, according to Professor Doernberg, the history of the permanent establishment concept suggests that the concept is capable of being adapted²¹⁹. The permanent establishment rule may be sufficiently flexible to permit treaty partners to interpret the permanent establishment concept in accordance with the need to respond to a digital economy. 'Any adaptation of existing international taxation principles should be structured to maintain fiscal sovereignty of countries, to achieve a fair sharing of the tax base and to avoid double taxation and unintentional non taxation.'²²⁰ Thus, there is no need to change the definition of permanent establishment.²²¹ Craig supports this, stating that the favoured solution lies in the redefinition of permanent establishment

²¹⁶ Cockfield (2002) 1.

²¹⁷ Ibid. See also Skaar (1991) op cit (fn 162) 65-101.

²¹⁸ Cockfield (2002) 7.

²¹⁹ Doernberg, Hinnekes, Hellerstein & Li (2001) 349.

²²⁰ Ibid.

²²¹ Ibid 352.

along the lines put forward by the OECD.²²² However, care should be taken to ensure a uniform approach to interpretation permanent establishment as redefined to avoid anomalies.

A possible approach suggested by Doernberg and Hinnekens would be to re-source and re-invent the concept and look for a permanent establishment fiction, e.g. a 'virtual' permanent establishment.²²³ This permanent establishment fiction would lower the threshold by deleting the requirement of a fixed place of business and by adapting the scope of the excluded auxiliary activities. A suitable permanent establishment definition (or fiction) should take into account the unique characteristics of the digital economy. In particular, it should reflect the productivity of the medium and the disintermediation permitting greater cooperation and contact in both business to business and business to consumer relationships.²²⁴ However, this 'virtual permanent establishment' approach raises a number of criticisms.²²⁵ First, the advent of e-commerce is merely a further step in an ongoing natural process of economic development which does not warrant a change in the permanent establishment concept. Second, the permanent establishment concept is capable of being adapted along the lines of the OECD. Therefore, there is no need to change the permanent establishment definition. Third, adapting the permanent establishment threshold to a level, which constitutes an appropriate jurisdictional framework for the source-based taxation of electronic commerce, is a daunting task. Finally, the need to re-invent the permanent establishment concept would require an overt change in Article 5 of the OECD Model Tax Treaty. Such a treaty change would not

²²² OECD Clarification on the Application of the Permanent Establishment Definition in E-commerce (2000). Craig (2000) 27

²²³ Doernberg, Hinnekens, Hellerstein & Li (2001) 353.

²²⁴ *Ibid.*

²²⁵ *Ibid.*

be an easy process. It is clear that an elaboration of this approach requires further study, experience, and acceptance.

However, those who advocate that e-commerce will require changes in taxing rules also think that it is premature to consider such changes at this point with electronic commerce still in its infancy.²²⁶ A wait-and-see approach to this matter appears to be a rational response to the challenges created by electronic commerce on the current system of international income taxation.²²⁷ It is not relevant to rush for a decision that could be premature as both businesses and tax authorities need a clear and definite guideline in handling taxation of electronic commerce.

4.3.5 Profits Attributable To Computer Servers

Profits are 'attributable to' a permanent establishment if they result from the economic activities of the permanent establishment. However, where a permanent establishment does not exist, the OECD is attempting to develop a model for determining the amount of income that should be attributed to the e-commerce operations carried on through computer equipment. In February 2001, a Technical Advisory Group (TAG) of the OECD issued a draft report titled, 'Attribution of Profit to a Permanent Establishment involved in Electronic Commerce Transactions'.

The TAG does not think that current rules, under which the OECD Model Tax Convention as interpreted, will always lead to results where the profits attributed to the exploitation of intangibles vest in the country in which those intangibles are created.

²²⁶ OECD E-commerce (1998) para 4, see also Bick 'Why Should the Internet Be Any Different?' 19 *PACE L. REV* 41, 65 (1998).

²²⁷ Guelman (2000) 51.

Thus, the TAG points out deficiencies in the current rules, and calls for suggestions as to how the rules need to be changed.²²⁸

The TAG has had the difficult task of dealing with this issue, as there are many variations in which non-resident companies will do business in the future, thus it is not possible to write a full set of comprehensive rules to determine how much of income should be attributed to an e-commerce operation. They suggest that the following determinations have to be decided upon:

- Entrepreneurial risk associated with an activity;
- Assets economically owned and exploited;
- Adequate compensation for services provided.

Therefore, in making these determinations there are no objective guidelines and it will be impossible for any two analysts to arrive at the same conclusions.²²⁹

The report states that the amount of income to be attributed to a permanent establishment is related to the nature of the functions that it performs, taking into account the assets used and risks assumed.²³⁰ Further, 'given the importance of intangibles assets in the earnings of profits from e-commerce activities, it is also essential to determine which part of the enterprise economically 'owns' or has created the intangible assets used by the permanent establishment.'²³¹

If a computer server causes a company to have a permanent establishment in a particular jurisdiction, and the company has no employees and does not own intangible

²²⁸ Hardesty Allocating Profit to a Web Server (2001) 3.

²²⁹ Ibid 14.

²³⁰ OECD Profits attributable to a permanent establishment (2000).

²³¹ Ibid.

assets in that particular jurisdiction, the amount of income attributable to the permanent establishment is not substantial.

If personnel are present in the jurisdiction to perform maintenance on the server, and to address problems affecting the operation of the web site, the amount of profit attributable to the server should be commensurate with what an independent service provider hired to perform the same functions that they would be expected to earn.

Where activities take place on one or more web servers making use of software, intangibles and computer hardware, the TAG concludes that the profits resulting from these activities are due mainly to the exploitation of these assets, and these profits should be attributed to the economic owners of the assets. The TAG also concludes that, relatively, profit should be attributed to the transactions processing functions taking place on the web servers, since they are administrative and support functions. The economic ownership is the key as opposed to the legal ownership. The economic ownership of intangibles are attributed to a head office, and not the permanent establishment created by the web server. It is not certain whether this approach will be accepted as it is a good theoretical approach but in practice, it is very difficult to administer.²³²

4.3.6 Conclusion

The concept of permanent establishment poses a challenge to the virtual world, as an e-commerce model can operate with fewer physical locations than under the traditional model. The definition of permanent establishment is difficult in the digital economy especially when determining whether a non-resident enterprise, which conducts e-commerce business in a jurisdiction, does so through a permanent establishment in that

²³² Hardesty (2001) 15.

jurisdiction. The OECD have provided useful guiding principles in the determination of a permanent establishment in the electronic commerce world, which are as follows:

- A web site cannot, in itself, constitute a permanent establishment;
- A web site hosting arrangement – where the web site of a business is hosted by an Internet Services Provider (ISP) typically does not result in a permanent establishment;
- An ISP will not constitute a dependent agent of another agent so as to constitute a permanent establishment of that enterprise;
- A business that owns or leases a server will not have a permanent establishment where the server is located;
- A permanent establishment may be found to exist even in the absence of human personnel;
- Certain functions that are considered auxiliary or preparatory will not give rise to a permanent establishment;
- While a place where computer equipment such as a server, is located may in certain circumstances constitute a permanent establishment, this requires that the functions performed at that place be significant as well as an essential or core part of the business activity of the enterprise.

These recommendations highlight the substance over form approach in determining the existence of a permanent establishment as well as place electronic commerce on an equal footing with the traditional commerce. This is in compliance with the OECD's basic principles of neutrality. However, it is debatable whether the OECD's clarification of the definition of permanent establishment has helped restore the equitable sharing of tax revenues between residence and source countries.²³³ It has been stated that in

²³³ Chetcuti (2002) 7.

determining the course of action to be taken the OECD must consider how the permanent establishment concept can be manipulated by businesses creating tax advantages, thereby causing an imbalance in worldwide fiscal and income tax status. In addition, servers would be positioned in a low tax or no tax jurisdiction, thus saving taxes. Following from the above analysis, the question is whether the traditional concept of permanent establishment is still viable in the era of e-commerce. Having fully examined the existing concept of permanent establishment it is submitted that the concept should be retained. The permanent establishment rules was designed with practicality and convenience in mind and serves the interests of fairness.

Leaving the permanent establishment concept unchanged does not preclude the need for interpretation or adaptation to clarify and fortify its application to e-commerce. To prevent the risk of double or non-taxation consensus is needed in applying the permanent establishment principle.

4.4 Characterisation of Income

Under the complex rules of taxation, it can matter greatly as to how a particular item of income is characterised. Most of the controversy in characterising e-commerce is between classifying payments resulting from digital transactions as either business profits or royalties. This is a key distinction because the taxation of business profits and royalties can differ greatly. Generally, in transactions involving two treaty countries, business profits are taxable in a country if they are associated with a permanent establishment in that country. On the other hand, royalties arising in a country are often taxed in the country regardless of whether there is a permanent establishment.

The current rules that distinguish royalty payments and payments for purchases of goods and services (from which tax does not usually have to be withheld) were

developed in relation to physical products and do not always work properly in relation to intangible products such as a digital image acquired over the Internet.

The characterisation of income from e-commerce transactions can result in two potential problems: viz;

- a) Firstly, different countries may impose different taxes on the same electronic transaction, thereby creating administrative difficulties for the business and an incentive to be selective where the business is established and
- b) The disparity between the taxation of the same product purchased through conventional means versus electronic means may result in inequitable tax treatments between traditional and electronic goods of the same nature.

The objectives of this section is to identify and classify the different types of income that can be earned by trading over the Internet, as different tax consequences will result depending on the tax character of income. To achieve this objective, a detailed examination of the different types of income will be discussed.

4.4.1 Character of Payments

Transactions over the Internet, however, are exposed to many problems in determining the true character of income earned. This can be illustrated by means of an example. Companies providing software products on-line can offer their customers the following options:

- View the software and/or a description of its operations;
- Download a modified version for the purpose of 'test driving' the software;
- Download one copy of the full version of the software for operation on the customer's computer; and/or

- Download the software for the purpose of copying it to the other computer.²³⁴

Depending on the rights that are transferred under the transaction, the payment might be characterised as a payment for:

- The sale of the goods;
- The provision of services;
- The use of or right to use an intangible;
- Transfer of know-how.²³⁵

Each of the above components will be discussed in turn to distinguish the nature of the transactions which give rise to the income. Examples are also included to add clarity to the discussion.

4.4.1.1 The Sale of Goods

The sale of goods involves tangible goods. With regard to the advent of electronic commerce, the identification of the sale of tangible goods presents no new difficulties. These transactions are transparent and easily accounted for and no complexities arise in determining the characterisation of the income arising. Tangible goods are delivered via the traditional methods as opposed to the electronic. The purchase price and profit is easily determined, and the treatment of profit falls under the normal taxation rules. Transactions involving tangible goods may result in either a sale or rental, depending on the rights in the property acquired by the customer. Thus, the transaction is clear and ownership and control is clearly distinct. However, the transaction may result in either a sale or rental, depending on the rights in the property acquired by the customer.

²³⁴ Australian Taxation Office (1999) para 1.14.

²³⁵ Ibid. See also Jenkins (1998) 150.

An example of the sale of goods is the electronic order and processing of tangible goods. This is whereby a customer selects an item from an online catalogue of tangible goods and orders the item electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The product is physically delivered to the customer by a common carrier.²³⁶

4.4.1.2 The Provision of Services

The characterisation of services provided online is generally unproblematic since services are services. However, digitised products may be characterised as either services or intangible property.

The following are examples of the various categories of typical e-commerce transactions that give rise to the provision of services.²³⁷ Under each fact situation is the analysis of the TAG report.

- Electronic ordering and downloading of digital products

The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is separate charge to the customer for using the online catalogue. The digital product is downloaded onto the customer's hard disk or other temporary media.

- Updates and add-ons

The provider of the software or other digital product agrees to provide the customer with updates and add-ons to the digital product. There is no agreement to produce updates or add-ons specifically for a given customer.

²³⁶ OECD Tax Treaty Characterisation Issues Arising from E-commerce (2001) 20.

²³⁷ These examples have extracted from the OECD Tax Treaty Characterisation Issues Arising from E-commerce (2001) 20-32.

- Limited duration software or other digital information licenses

The customer receives the right to use software or other digital products for a period of time that is less than the useful life of the product. The product is either downloaded electronically or delivered on a tangible medium such as a CD. All copies of the digital product are deleted or become unusable upon termination of the license.

- Single- use software or other digital product

The customer receives the right to use software or other digital products one time. The product may be either downloaded or used remotely (e.g. use of software stored on a remote server). The customer does not receive the right to make copies of the digital product other than as required to use the digital product for its intended use.

- Application hosting – separate licensing

A user has a perpetual license to use a software product. The user enters into a contract with a host entity whereby the host loads the software copy on servers owned and operated by the host. The host provides technical support to protect against failures of the system. The user can access, execute, and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. This type of arrangement could apply, for example, for financial management, inventory control, and human resource management.

- Application hosting – Bundled contract

For a single, bundled fee, the user enters into a contract whereby the provider, who is also the copyright owner, allows access to one or more software applications, hosts the

software applications on a server owned and operated by the host, and provides technical support for the hardware and software. The user can access, execute, and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's sever. The contract is renewable annually for an additional fee.

- Application service provider (ASP)

The provider obtains a license to use a software application in the provider's business of being an application service provider. The provider makes available to the customer access to a software application hosted on computer servers owned and operated by the provider. The software automates a particular back-office business function for the customer. For example, the software might automate sourcing, ordering, payment, and delivery of goods or services used in the customer's business, such as office supplies or travel arrangements. The provider does not provide the goods and services. It merely provides the customer with the means to automate and manage its interaction with third-party providers of these goods and services. The customer has no right to copy the software or to use the software other than on the provider's server, and does not have possession or control of a software copy.

- ASP license fees

In the above example, the application service provider pays the provider of the software application a fee, which is a percentage of the revenue, collected from customers. The contract is for a one-year term.

- Web site hosting

The provider offers space on its server to host web sites. The provider obtains no rights in the copyrights created by the developer of the web site content. The owner of the copyrighted material on the site may remotely manipulate the site, including modifying the content on the site. A fee based on the passage of time compensates the provider.

- Software maintenance

Software maintenance contracts typically bundle software updates together with technical support. A single annual fee is charged for both updates and technical support. In most cases, the principal object of the contract is the software updates.

- Customer support over a computer network

The provider provides the customer with online technical support, including installation advice and trouble-shooting information. This support can take the form of online technical documentation, a trouble-shooting database, and communications (e.g. by e-mail) with human technicians.

- Data warehousing

The customer stores its computer data on computer servers owned and operated by the provider. The customer can access, upload, retrieve, and manipulate data remotely. No software is licensed to the customer under this transaction. An example would be a retailer who stores its inventory records on the provider's hardware and the persons on the customer's order desk remotely access this information to allow them to determine whether orders could be filled from current stock.

- Data retrieval

The provider makes a repository of information available for customers to search and retrieve. The principal value to customers is the ability to search and extract a specific item of data from amongst a vast collection of widely available data.

- Delivery of exclusive or other high-value data

As in the previous example, the provider makes a repository of information available to customers. In this case, however, the data is of greater value to the customer than the means of finding and retrieving it. The provider adds a significant value in terms of content (e.g. by adding analysis of raw data) but the resulting product is not prepared for a specific customer and no obligation to keep its contents confidential is imposed on customers. Examples of such products might include special industry reports or investment reports. Such reports are either sent electronically to subscribers or are made available for purchase and download from an online catalogue or index.

- Advertising

Advertisers pay to have their advertisements disseminated to users of a given web site. So-called “banner ads” are small graphic images embedded in a web page, which when clicked by the user will load the web page specified by the advertiser. Advertising rates are most commonly specified in terms of a cost per thousand “impressions” (number of times the ad is displayed to a user), though rates might also be based on the number of “click-throughs” (number of times the ad is clicked by a user).

- Electronic access to professional advice (e.g. consultancy)

A consultant, lawyer, doctor or other professional service provider advises customers through e-mail, video conferencing, or other remote means of communication.

- Information delivery

The provider electronically delivers data to subscribers periodically in accordance with their personal preferences. The principal value to customers is the convenience of receiving widely available information in a custom-packaged format tailored to their specific needs.

- Subscription-based interactive web site access

The provider makes available to subscribers a web site featuring digital content, including information, music, video games, and activities (whether or not developed or owned by the provider). Subscribers pay a fixed periodic fee for access to the site. The principal value of the site to subscribers is interacting with the site while online as opposed to getting a product or services from the site.

- Online shopping portal

A web site operator hosts electronic catalogues of multiple merchants on its computer servers. Users of the web site can select products from these catalogues and place orders online. The web site operator has no contractual relationship with shoppers. It merely transmits orders to the merchants, who are responsible for accepting and fulfilling orders. The merchants pay the web site operator a commission equal to a percentage of the orders placed through the site.

- Online auctions

The provider displays many items for purchase by auction. The user purchases the items directly from the owner of the items, rather than from the enterprise operating the site. The vendor compensates the provider with a percentage of the sales price or a flat fee.

- Sales referrals programs (e.g. commission)

An online provider pays a sales commission to the operator of a web site that refers sales leads to the provider. The web site operator will list one or more of the provider's products on the operator's web site. If a user clicks on one of these products, the user will retrieve a web page from the operator's site from which the product can be purchased. When the link on the operator's web page is used, the provider can identify the source of the sales lead and will pay the operator a percentage commission if the user buys the product.

- Content acquisitions transactions

A web site operator pays various content providers for news stories, information, and other online content in order to attract users to the site. Alternatively, the web site operator might hire a content provider to create new content specifically for the web site.

- Streamed (real time) web based broadcasting

The user accesses a content database of copyrighted audio and/or visual material. The broadcaster receives subscription or advertising revenues.

- Carriage fees

A content provider pays a particular web site or network operator in order to have its content displayed by the web site or network operator.

- Subscription to a web site allowing the downloading of digital products

The provider makes available to subscribers a web site featuring copyrighted digital content (e.g. music). Subscribers pay a fixed periodic fee for access to the site. The principal value of the site to subscribers is the possibility to download these digital products.

4.4.1.3 The Use of or Right to Use an Intangible

Electronic ordering and downloading of digital products for the purposes of copyright exploitation results in royalties. A royalty income allows the source jurisdiction to impose withholding tax on the gross amount of the royalty payments. It would be unworkable to impose royalty withholding tax on a large number of small consumer transactions in copyrighted transactions. Royalty treatment is for commercial reproduction licenses and similar partial transfers of intellectual property rights.²³⁸ Royalties are taxed only in the country of the beneficial owner of the royalties, unless the royalties are earned through a permanent establishment in the other country.

The definition of 'royalties' can be found in paragraph 2 of Article 12 of the OECD Model Tax Convention, which means:

'Payments of any kind received as a consideration for the use of, or the right to use, any copyright of literacy, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.'²³⁹

²³⁸ Hardesty Character of E-commerce Transactions (2001) 16.

²³⁹ OECD Model Tax Treaty (2003).

The consideration that is covered in Article 12 of the OECD Model Tax Convention includes payment in money or in money's worth. The payment must pass from the licensee to the licensor. Exploitation of the payment by the licensor would not fall within the scope of Article 12. For example, if the licensor sold a royalty contract to a third party, the payments received from the purchaser would not constitute royalties within the meaning of Article 12(2).²⁴⁰ Neither Article 12²⁴¹ nor any other treaty provision contains a definition of 'use'. Doernberg in asserting meaning to the term 'for use of, or the right to use', states that a distinction must be made between licensing rights to an underlying asset on the one hand and the alienation or transfer of the underlying asset on the other hand.²⁴² The former constitutes the 'use' of the assets in question and the latter will not constitute 'use'.²⁴³ There is another distinction to be made concerning the term 'use'. If the potential licensor uses the royalty property within the framework of an advisory activity, fees paid for services are not royalties within the meaning of Article 12(2). The concept of 'use' lies somewhere between outright alienation for a single, fixed amount and the complete retention of the property in question by the owner who, by using it, renders services for the customer.²⁴⁴ However, if a licensee makes a payment for the right to use royalty property but does not in fact use the property, the payment will nevertheless constitute a royalty under Article 12(2). This 'right to use' language should cover any amounts paid for an option to use royalty property regardless of whether the royalty property is in fact used.²⁴⁵

²⁴⁰ Doernberg, Hinnekens, Hellerstein & Li (2001) 290.

²⁴¹ OECD Model Tax Treaty (2003).

²⁴² Doernberg, Hinnekens, Hellerstein & Li (2001) 290

²⁴³ Ibid.

²⁴⁴ Ibid.

²⁴⁵ Ibid.

An example of the use of or right to use an intangible is the content acquisition transaction (online information and news stories) whereby a web site operator pays various content providers for news stories, information, and other online content in order to attract users to the site. Alternatively, the web site operator might hire a content provider to create new content specifically for the web site. The payment for the right to display existing copyrighted content results in royalties.

4.4.1.4 Transfer of Know-How

'Know-how' is:

'undivulged technical information" for payment of information concerning 'industrial, commercial or scientific experience that is necessary for the 'industrial reproduction of a product or process.'²⁴⁶

Thus, it results in royalties. Under treaties that permit source country taxation of royalties, there may be an incentive for a source country to characterise some payments as know-how rather than payment for services. Payments for know-how would constitute a royalty which could permit source country taxation whereas business profits are not taxable in the source country in the absence of a permanent establishment.²⁴⁷ An example of the transfer of know-how is technical information whereby the customer is provided with undivulged technical information concerning a product or process (e.g. narrative description and diagrams of a secret manufacturing process).²⁴⁸

4.4.2 Services versus Sales of Goods

In order to determine whether the income derived from an electronic sale of software, gives rise to royalty income or business profits it is necessary to draw a distinction between the sale of goods and services. The basic distinction between transactions in

²⁴⁶ Paragraph 11 of the OECD Model Treaty (2003).

²⁴⁷ Hardesty Tax Character of E-commerce (2001) 5.

²⁴⁸ OECD Tax Treaty Characterisation Issues Arising from E-commerce (2001) 29.

goods versus services is whether the customer acquires a property (software, music, video images or other forms of digital information and content) from the provider.²⁴⁹ Implicit in the concept of services income is the notion that the value conferred on the purchaser does not take the form of a cognizable property interest.²⁵⁰ Therefore, if the seller transfers property rights to the purchaser, the transaction should be characterised as a transfer of property (either sale or rental) rather than the provision of a service. On the other hand, if the customer does not receive an interest in the property, then revenue should be characterised as revenue from services.²⁵¹

When a customer receives property in connection with the rendition of services by the vendor, it is necessary to determine whether the income from the transaction should be characterised as services income or income from the sale of goods. If the customer owns the property after the transaction, but ownership of the property was not transferred from the vendor to the customer, then the transaction is to be treated as a services transaction. For example, if the customer engages the vendor to create an item of property that will be owned from the moment of its creation, then no property will have been transferred from the vendor to the customer, and the transaction should be characterised as the provision of services.²⁵²

The Boulez case²⁵³ demonstrates that double taxation occurs in the absence of consistent characterisation rules among nations. The United States claimed that the compensation paid to Boulez was compensation for personal services, while Germany took the view that the compensation represented royalties that were exempt from United

²⁴⁹ Reid (2001) 198.

²⁵⁰ Ibid.

²⁵¹ Ibid.

²⁵² Boulez v Commissioner, 83 T.C. 584 (1984).

²⁵³ Ibid.

States tax. Boulez sought relief from the competent authorities of the two countries, but no agreement could be reached. Thus, Boulez was subject to double taxation on his income, notwithstanding the provisions of the tax treaty.²⁵⁴

4.4.3 Services versus Leasing

When a customer receives a temporary interest in property in connection with the rendition of services by the vendor, it often becomes necessary to determine whether the income from the transaction should be characterised as 'services income' or 'rental income'.

A limited-duration license to use software or other digital products will typically result in rental income. The customer usually has possession and control of the digital product, operates the product, has exclusive use of the product for a significant period of time, and typically pays a fee based on the passage of time.

In contrast to a limited-duration license, a license for a single use of a software program or other digital product arguably should result in services income. The customer lacks possession and control of digital product, has the use of the product for a single use rather than for a specific amount of time, and pays a fee based on usage rather than the passage of time and which is not related to the fair rental value of the product.

Application service provider (ASP) transactions, in many contexts, should also give rise to services income.

²⁵⁴ Reid (2001) 198.

4.4.4 Clarification of the Characterisation of Income in E-commerce

In February 2001, a Technical Advisory Group (TAG) of the OECD issued final recommendations on the character of e-commerce transactions. The report of the TAG is titled 'Tax Treaty Characterisation Issues Arising from E-commerce'. If adopted the recommendations will become part of the Commentaries used to interpret the OECD Model Tax Convention. The analysis and conclusions in the TAG's report provides the much-needed clarity for the taxation of e-commerce. What follows is an analysis of the report.²⁵⁵

4.4.4.1 Business Profits and Payments for the Use of, or the Right to Use, a Copyright

In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of the consideration for payment. Where the essential consideration is something other than the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of the copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for purposes of applying the definition of 'royalties'. This is the case where a customer is allowed to electronically download software, images, sounds, or texts for their own use or enjoyment. The payment is made to acquire data transmitted in the form of a digital signal for the acquiror's own use or enjoyment. This constitutes the essential consideration for payment, which therefore does not constitute royalties but falls within Article 7.²⁵⁶ The act of copying the digital

²⁵⁵ OECD Treaty Characterisation Issues Arising from E-commerce (2001) paras 11-25.

²⁵⁶ OECD Model Tax Convention (2003).

signal onto customer's hard disk is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment, which is the determining factor for the purposes of the definition of royalties.

4.4.4.2 'Business Profits' and Payments for 'Know-how'

In a 'know-how' contract, a participant agrees to impart to another, so that he can use it for his own account, his special knowledge and skills will not be revealed to the public. Therefore, a 'know-how' contract differs from contracts that are for the provision of services. In a provision of services contract a participant uses customary skills of his calling to execute work himself for the other participant. The fact that the two types of payments i.e. payments for the supply of know-how and payments for the provision of services gives rise to difficulties means that it is necessary to distinguish between these two types of payments. The following criteria are relevant for the purpose of making that distinction²⁵⁷:

- Contracts for the supply of know-how concern information that already exists.
- In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not transfer of such knowledge, skill or expertise to the other party.
- In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a

²⁵⁷ Ibid para 11.3.

contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to a sub-contractor for the performance of similar services.

- In the particular case of a contract involving the provision of services, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade protection.²⁵⁸

4.4.4.3 Business Profits and Payments for the Use of, or the Right to Use, Industrial, Commercial, or Scientific Equipment

a) Digital products

The term 'payments for the use of, or the right to use, industrial, commercial or scientific equipment' is applicable for payments of time-limited use of a digital product.²⁵⁹ The payments for such use of digital products cannot be considered as payments 'for the use of, or the right to use, industrial, commercial or scientific equipment' for the following reasons²⁶⁰:

- the word 'equipment' applies to a tangible product;

²⁵⁸ Ibid.

²⁵⁹ OECD Tax Treaty Characterisation Issues Arising from E-commerce (2001) para 26.

²⁶⁰ Ibid.

- in the definition of 'royalties' equipment applies to property that is intended to be an accessory in an industrial, commercial or a scientific process and therefore could not apply to intangible property such as music or a video;
- the payment involved cannot be considered to be 'for the use, or the right to use' the product since these words do not apply to a payment made to acquire a property which has a short useful life, which is the case for most products.

b) Computer Equipment

The TAG Group also examined various factors used to distinguish rental from service contract transactions and found the following factors to be useful for the purposes of determining whether payments are for 'the use of, or the right to use, industrial, commercial or scientific equipment'. The following factors indicates a lease rather than the provision of services²⁶¹:

- the customer is in physical possession of the property;
- the customer controls the property;
- the customer has a significant economic or possessory interest in the property;
- the provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract;
- the provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient;
- the total payment does not substantially exceed the rental value of the computer equivalent for the contract period.

²⁶¹ Ibid para 28.

Applying these facts, the TAG²⁶² concluded that where a customer uses online software, as opposed to applications operated by an ASP, the payments should give rise to services income as opposed to rental payments. In a typical transaction, the service provider uses the software to provide services to customers, maintains the software as needed, owns the equipment on which the software is loaded, provides access to many customers to the same equipment, and has the right to update and replace the software at will. The customer may not have possession or control over the software or the equipment, will access the software concurrently with other customers, and may pay a fee based on the volume of transactions processed by the software.²⁶³

4.4.4.4 Technical Fees

Technical fees are defined as:

‘a payment of any kind to any person, other than to an employee of the person making payments, in consideration for a service of a technical, managerial or consultancy nature.’²⁶⁴

The TAG Characterisation Report points out that the delivery of a service through technological means does not make it a technical service. In addition, technical skill or knowledge which is used to develop inputs to a service business does not render the performance of services technical in nature. For example, special skill is required to develop an internet database that will attract fee-paying customers. However, those skills are not directly used when a customer consults the database. Accordingly, the customer’s fee is a payment of services.²⁶⁵ A similar approach is suggested for managerial and consultancy services.

²⁶² Hardesty Character of E-commerce (2001) 13.

²⁶³ Ibid. A further example is that of data warehousing.

²⁶⁴ OECD Tax Treaty Characterisation Issues Arising from E-commerce (2001) para 35.

²⁶⁵ Ibid para 39-42.

4.4.4.5 Mixed Payments

Mixed payments is where the payment might be partly for services, partly for the use of intellectual property, partly for know-how, etc. However, it would be more practical and more consistent with the OECD Commentaries to make the treatment applicable to the principal part of the payment applicable to the entire payment.²⁶⁶

4.4.5 Conclusion

Failure to deal with digital products leaves web-based vendors of electronic books, music, and video with uncertainty in characterising cross-border transactions. If the International community cannot reach an agreement on these classification issues, or do not share the same definition of a particular category of income, this would lead to more tax planning opportunities for the taxpayer. The approach taken by the OECD is to apply the existing rules to e-commerce which is to characterise income as either business profits, royalties or services fees, however, it is submitted that without sound regulations the application of traditional tax principles to electronic transactions, may lead to impractical results with minor differences in the nature or mode of delivery of a product leading to significantly different tax results, thus offending the principles of tax neutrality. Therefore, it is important to develop an international consensus on the correct characterisation of income received from e-commerce transactions, to avoid double taxation and non-taxation. The taxation of different types of income differ significantly, therefore a correct classification of income is fundamental. With the complexities surrounding taxation of electronic transactions, clarity and consistency should be the focus of standard setters, to maintain neutrality and to provide clearly defined guidelines.

²⁶⁶ Ibid paras 47-49.

4.5 Transfer Pricing

A host of taxation issues, fuelled by the significant developments in the field of e-commerce has already been highlighted. The concept of 'transfer pricing' also plays an integral part in the evolving telecommunications 'global economy'.

Transfer pricing is the term used to refer to the arrangements in which goods or services are transferred at an artificial price as a means of effectively transferring income or an expense between associated businesses.²⁶⁷

The complexity surrounding the determination of an 'arms length' price of goods and services transferred between associated companies is not new and is not exclusive to e-commerce. What is new, however, is the level of integration between business operations located in different countries, made possible by e-commerce. With associated businesses being located in many different countries, transfer pricing serves as the fundamental medium in determining how much profit is earned and taxed in each country.²⁶⁸ The ensuing discussion details the difficulties posed by e-commerce on transfer pricing, and an evaluation of how the existing rules can be applied to confront the difficulties posed. In particular, this section examines the transfer pricing rules, the corresponding problems and whether the arm's length method is still appropriate in the context of e-commerce.

²⁶⁷ Hardesty *Transfer Pricing and Electronic Commerce* (2002) 5.

²⁶⁸ *Ibid.*

4.5.1 The Difference between the Traditional and E-commerce

Tax authorities from all countries have expressed concern for the manipulation of transfer prices between associated companies that result in income distortions. Many jurisdictions²⁶⁹ including South Africa have reacted by passing legislation²⁷⁰ and Practice Notes on transfer pricing.²⁷¹

With the increase in electronic commerce, cross-border transactions between associated companies have been modified two-fold, viz in volume and variety. This creates a strain for the traditional transfer pricing methodologies.²⁷²

The following example serves to illustrate by the use of a diagram the new issues that have come up with the advent of e-commerce with respect to transfer pricing.²⁷³

4.5.1.1 The Traditional Business System

Example: A holding company in the United States of America researches, tests and designs a certain financial device to predict stock market trends. Its wholly owned subsidiary in the United Kingdom uses the technology and design of the holding company to manufacture components for the device. The components are then assembled in the United States of America to produce the finished product. The United Kingdom Company is responsible for all sales out of the United States.

²⁶⁹ For example United States of America and Belgium.

²⁷⁰ Section 31 of the Income Tax 58 of 1962.

²⁷¹ South African Revenue Services Practice Note 7 as at 6 August 1999.

²⁷² Hardesty Transfer Pricing and E-commerce (2002) 5.

²⁷³ The example is sourced from Hardesty Transfer Pricing and E-commerce (2002) 13.

Holding Company - USA		Subsidiary Company - UK
<p>1. Technology researched and developed in USA</p> <p>Design licensed to the UK subsidiary.</p>	<p>Transfer pricing applies to the licensing and the use of the technology by the UK subsidiary. →</p>	<p>Subsidiary company uses design to manufacture components unassembled.</p>
<p>2. The unassembled components are assembled by the holding company, into the finished goods.</p>	<p>← Transfer pricing applies to the sale of unassembled components to the holding company.</p>	<p>Components manufactured are shipped to the holding company for assembly.</p>
<p>3. The finished product passes through quality control and then sold to the subsidiary for distribution.</p>	<p>Transfer pricing applies to the sale of finished goods to the subsidiary company. →</p>	<p>Finished goods are purchased from the holding company for distribution in the locality.</p>

In the above example, the transaction between the two companies is clearly defined and can be easily identified. However, electronic commerce now enables companies to integrate many of their functions and processes. This integration increases complexity and transactions become more difficult to identify and less clearly defined.

The following example illustrates a typical situation where electronic commerce is introduced into traditional business operations.²⁷⁴

²⁷⁴ Ibid.

4.5.1.2 The Electronic Business System

The relationship between the two companies remains the same. However, through the Internet, many functions and processes can be carried out in real time. Administrative functions can be performed on-line. The top-level management is based in the United States and the United Kingdom. Important business decisions are taken via teleconferencing. There is constant interaction between employees of the two companies regarding product development, marketing strategies, and design technologies, etc.

Holding Company - USA		Subsidiary Company –UK
1. Research and development, design, testing, etc done partly by the holding company.	<p>←The product technology is licensed to both companies. The challenge posed to the existing transfer pricing provisions is: a) how to apportion ownership rights between the two companies and how to ascertain a fair percentage if ownership is shared. b) How to determine an arm's length price for skills transfer from subsidiary company to</p>	The subsidiary company also employees skilled workers that assist with design, product development, etc.

	holding company. →	
2. Administrative functions, e.g. accounting, tax procurement, etc. are centralised in the head office of the holding company and these services are performed for the subsidiary company, through an Internet based system.	← The performance of these functions may be charged to the subsidiary company, however, the challenge faced is how to place a value on these services. An arm's length price can be established using services provided by a similar company, however, it could be argued that these services are performed for the better operation of the business as a whole; therefore, the costs should be absorbed by the holding company. →	
3. The chairperson, chief financial officer, and chief administrative officer are based in USA.	←Key decision-making personnel are distributed between the USA and UK. The contributions made by individual personnel cannot	The marketing director, chief IT officer, and brand manager are based in the UK.

	<p>be easily valued. Policies are applied consistently between the two companies. The value added by the skill of directors may come under the spotlight of the transfer pricing provisions, and create additional difficulties in identification and valuation. →</p>	
<p>4. Constant interaction between the operational staff of the holding company and their subsidiary company - colleagues, regarding product design and development, marketing strategies, etc.</p>	<p>←Each interaction or communication adds to the value of the enterprise and needs to be priced. Difficulties arise as, a huge volume of transactions occurs that is not clearly defined, and cannot be easily valued, due to insufficient supporting information. →</p>	<p>Constant interaction between the operational staff of the subsidiary company and their holding company Colleagues, regarding product design and development, marketing strategies, etc.</p>

4.5.2 The Problems Posed by E-commerce to the Existing Transfer Pricing Provisions

The following is a discussion of the problems posed by e-commerce to the existing transfer pricing provisions.

4.5.2.1 Identifying Transactions of Value in Highly Integrated Businesses

As illustrated in the example of an electronic business system, the Internet has stimulated increased interaction between associated companies. There has been a corresponding increase in the level of complexity, as business operations become more integrated.²⁷⁵ The OECD Guidelines has raised the concern that the increasing integration of business operations in the 'virtual mall' may necessitate the need to reassess current tax treatments. The electronic medium facilitates a tremendous upward swing in volume and variety of transactions; each of the thousands of cross-border interactions enhances the business operations and may need to be valued. The crux of the transfer pricing provisions is to identify transactions and apply the 'arm's length' principle to these transactions. With the communication boom between associated companies, numerous informal transactions occur and the problem that arises is how to identify the transactions that may constitute 'transfer of values'. The practicality of separately identifying individual transactions, in a highly integrated enterprise, needs to be assessed.²⁷⁶ Unclear transactions that are not easily defined and insufficient supporting information not only put a strain on the identification, but also create additional valuation problems.²⁷⁷

²⁷⁵ Ibid.

²⁷⁶ Ibid.

²⁷⁷ Ibid.

4.5.2.2 Locating Appropriate Comparable Transactions

The 'arm's length' principle requires a comparison of the conditions in a transaction between connected persons with the conditions in transactions between independent parties, i.e. it is essentially based on the premise that comparable transactions between independent parties should be used as a benchmark against which to evaluate a fair price.²⁷⁸ This will be difficult, however, because of the integration of the business operations, resulting in drawing comparisons between the functions performed by a 'traditional economy' enterprise and a 'new age economy' business. Another problem to be considered is the current lack of reliable comparables. The starting point to any comparability analysis is to gain an understanding of how unrelated companies would evaluate the potential transaction. The compensation arising from transactions between two independent parties will usually reflect the functions that each party performs, taking into account the assets used and the risks assumed. In order to determine comparability between two transactions, a functional analysis must be conducted, i.e. the functions performed and the risks assumed by the independent parties should be comparable to those undertaken by connected persons.²⁷⁹ The primary purpose of this functional analysis is to determine whether transactions of unrelated parties are comparable with the transaction being tested.²⁸⁰

The functional analysis requires a close understanding of particular business functions. In order to perform a comparability analysis the following factors need to be assessed:

- The functions Performed

This refers to relative importance of the functions performed by each party and to the transaction. When various functions are performed by associated enterprises, the

²⁷⁸ SARS Practice Note 7 (1999) para 7.3.

²⁷⁹ Ibid.

²⁸⁰ Ibid para 8.1.6. See also Desai (2001) 20-23.

enterprise that provides most of the effort and the rare or unique functions, and assumes the most risk, should earn a greater portion of the profit.

- Contractual Terms

The contractual terms of a transaction should define how the responsibilities, risks, and benefits are assigned to the parties.

- The risks assumed

It is also relevant to consider risks assumed by the respective parties, as an increased risk should indicate compensation by increased return.

- Economic conditions and marketplace circumstances

'Arm's length' prices for the same goods and services may vary across different markets. Competition, fluctuations in currency and pricing and size of the market should be considered. In order to assess comparability in a fair manner, it is important to ensure that the markets in which the parties operate are comparable.

- Characterisation of property or services

Differences in the specific characteristics of property or services account, at least in part, for differences in their value in the open market. The actual characteristics of a product or service being transferred, plays a significant role in determining the pricing method to apply to calculate an arms length price.

- Business strategies

Business strategies are a legitimate aspect of 'arm's length' operations. They take into account aspects such as innovation and new product development, degree of diversification, risk aversion and other factors which have a bearing on the daily conduct of business.

A functional analysis should be performed for both the company being tested and companies to be used as comparables, before a pricing method can be chosen. It should be noted however, that the functional analysis is not an alternative to determine comparables; it is a means to establish what sort of comparables should be sought.²⁸¹

4.5.3 Valuing Transactions – Choosing a Pricing Method

The next step after identifying a transaction of value and evaluating reliable comparables by functional analysis is to assign a fair price that rewards each party appropriately for their respective contributions to the transaction. The OECD Guidelines²⁸² have recognised several pricing methods, which have been included in Practice Note 7.²⁸³ The pricing methods are made up of two categories, viz traditional transaction methods and the transactional profit methods. Neither section 31²⁸⁴ nor the OECD Guidelines impose a hierarchy of a pricing method or a 'best method' rule. The OECD Guidelines suggest that the transactional profit methods might be applied as a case of last resort where the traditional transaction method cannot be reliably applied alone or cannot be applied at all, because of the information constraints, particularly the lack of comparable

²⁸¹ Desai (2001) 25.

²⁸² OECD Transfer Pricing Guidelines (1995).

²⁸³ South African Revenue Services Practice Note 7 which came into effect 6 August 1999.

²⁸⁴ Income Tax Act 58 of 1962.

uncontrolled transactions.²⁸⁵ The most feasible method will be the one that requires the least and most reliable adjustments. As a rule, the traditional transaction methods are preferred; however, many tax jurists are of the opinion that the use of profit-based transfer pricing methods may become more prevalent between associated enterprises engaged in e-commerce business.²⁸⁶ The different pricing methods will now be considered in detail.²⁸⁷ In particular, this section examines the existing transfer pricing methods, their uses and various shortcomings and whether the existing methods are still appropriate in the context of electronic commerce.

4.5.3.1 Traditional Transaction Methods

There are three traditional transaction methods recognized by the OECD's guidelines on transfer pricing. They are the comparable uncontrolled method, the resale price method and the cost plus method. Each of these will be discussed in turn.

4.5.2.2.1 The Comparable Uncontrolled Price Method

Description

In applying the comparable uncontrolled price method, a direct comparison is drawn between the prices charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction, in comparable circumstances. It primarily focuses on the goods being transferred or service being rendered, but also takes into account broader business functions and economic circumstances.

²⁸⁵ OECD Transfer Pricing Guidelines (1995) 31.

²⁸⁶ Hardesty Transfer Pricing and E-commerce (2002) 26.

²⁸⁷ These methods have been extracted from the SARS Practice Note 7 (1999) para 9.4 – 9.8.2.

Differences between the two prices may indicate the existence of 'non-arm's' length conditions and that the price in the controlled transaction may need to be substituted for the price in the uncontrolled transaction.²⁸⁸

Application

The comparable uncontrolled price method is the most direct and reliable way to apply the 'arm's length' principle where it is possible to locate comparable uncontrolled transactions. The two transactions being compared will only be truly comparable if there are no differences between the two transactions that will have a material effect on the price, or if reasonably accurate adjustments can be made to eliminate the effect of differences that may materially affect the price.²⁸⁹

Practical Problems

It is usually difficult to find a transaction between independent enterprises which is sufficiently similar to a controlled transaction, without differences which have a material effect on price.

Where differences exist between the controlled and uncontrolled transactions, or between the enterprises undertaking those transactions, it may be difficult or impossible to determine reasonably accurate adjustments to eliminate the effect on price.²⁹⁰

4.5.3.1.2 The Resale Price Method

Description

The resale price method is based on the price at which a product, which has been purchased from a connected enterprise, is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin, to cover the reseller's

²⁸⁸ SARS Practice Note 7 (1999) para 9.4.1

²⁸⁹ Ibid para 9.4.2.

²⁹⁰ Ibid para 9.4.3.

selling and other operating costs, and to provide an appropriate profit, depending on functions performed, assets used and risks assumed by the reseller. The balance may be regarded as the arm's length price before other adjustments in respect of, for example, customs duties.²⁹¹

Application

Functional comparability is important and it is essential that the functions performed by the independent entity are comparable to the functions performed by the member of the multinational selling to an independent enterprise.

In applying the resale price method, fewer adjustments are normally required for product comparability than under the comparable uncontrolled price method.

The resale price method focuses only on the external sale price to third parties and the gross margin required to reward the function performed by the seller.

The resale price method is most appropriate where the reseller does not add substantially to the value of the product nor does it not possess valuable marketing intangibles.²⁹²

Practical Problems

The biggest problem is to determine an 'arm's length' resale price gross margin. It is usually very difficult to find a transaction between independent enterprises that is similar to a controlled transaction and where differences do not have a material effect on the margin²⁹³.

²⁹¹ Ibid para 9.5.1.

²⁹² Ibid para 9.5.2.

²⁹³ Ibid para 9.5.3.

4.5.3.1.3 The Cost Plus Method

Description

The cost plus method requires the estimation of an arm's length consideration, by adding an appropriate mark-up to the costs incurred by the supplier of goods or services in a controlled transaction. This mark-up should provide for an appropriate profit to the supplier, in light of the functions performed, assets used and risks assumed.²⁹⁴

Application

This method is best suited to situations where:

- Services are provided;
- Semi-finished goods are sold between connected parties;
- Connected persons have concluded joint facility agreements or long-term buy-and-supply arrangements.²⁹⁵

The mark-up should ideally be determined with reference to the mark-up earned by the same supplier in uncontrolled transactions.

An uncontrolled transaction is comparable to a controlled transaction for purposes of the cost plus method if one of two conditions is met:

- None of the differences between the transactions being compared or between the enterprise undertaking those transactions materially affect the cost plus mark-up in the open market; or
- Reasonably accurate adjustments can be made to eliminate the material effects of such differences.²⁹⁶

²⁹⁴ Ibid para 9.6.1.

²⁹⁵ Ibid.

Practical Problems

The application of the cost plus method presents certain difficulties. The cost plus method may, in certain circumstances be difficult to apply in practice. For e.g. some companies will be more effective than others and will incur lower costs. In addition, there may be circumstances where there is no discernible link between the level of costs incurred and a market price.²⁹⁷

4.5.3.2 Transactional Profit Methods

When the traditional transaction methods fail to render a satisfactory result, the OECD Guidelines authorises the use of two transactional profit methods, i.e. the profit-split method and the transaction net margin method.²⁹⁸ The traditional transaction methods cannot be applied at all, when there is insufficient data on uncontrolled transactions, when data exists but is considered unreliable due to the nature of different business situations. Many tax jurists²⁹⁹ worldwide, however, realise that the transactional profits methods are somewhat more forgiving and flexible when unusual circumstances exist. Even when using profit-based pricing methods, there is a need to assess market data therefore; it should not be assumed that profit-based methods are immediate substitutes when transaction based methods become difficult to apply. As the arm's length principle has been used for determining transfer pricing for tax purposes, it is fundamental that non-traditional pricing methods would have to be applied in a manner that would protect the integrity of this principle.

²⁹⁶ Ibid para 9.6.2.

²⁹⁷ Ibid para 9.6.3.

²⁹⁸ OECD Transfer Pricing Guidelines (1995) 35.

²⁹⁹ Hardesty Transfer pricing and E-commerce (2002) 32.

4.5.3.2.1 The Transactional Net Margin Method

Description

The Transactional Net Margin Method examines the net profit margin that a taxpayer realises from a controlled transaction, relative to an appropriate base, for example cost, sales or assets. This ratio is referred to as a profit level indicator. The profit level indicator of the tested party is compared to the profit level indicator(s) of comparable independent parties.³⁰⁰

Application

Although the transactional net margin method is classified as a transactional profit method, it is more closely aligned to the cost plus and the resale profit methods than to the profit split method. The difference is that the transactional net margin method compares net profit rather than gross profit.

The transactional net margin method is, however, considered less reliable than the traditional transactional methods. This is because the net margins that are used in the transaction net margin method are very sensitive to the relative cost structures of the entities being compared, as they include operating expenses in their calculations.

This observation does not preclude the transactional net margin method from being used. It must be recognised that reliable information on gross margins may be difficult, if not impossible, to obtain. Thus, information constraints may dictate the transactional net margin method as the only practical approach in many cases.³⁰¹

³⁰⁰ SARS Practice Note 7 (1999) para 9.7.1.

³⁰¹ Ibid para 9.7.2.

The advantage of the transactional net margin method is that it does not rely on comparables in the same way as traditional pricing methods, and can be applied when the third party information is not sufficiently similar.³⁰²

Practical Problems

The net margin of a taxpayer can be affected by factors that do not necessarily have an influence on price or gross margins, thereby reducing the reliance that can be placed on the results in applying the transactional net margin method.

Information about the taxpayer, required to apply the transactional net margin method may not be available at the time of determining an 'arm's length' price. It may for example, not be possible to determine the net margin that will result from the controlled transaction. Information on the uncontrolled transaction may not be available.

As with the cost plus and resale profit methods, the transactional net margin method is a one-sided analysis, as it does not consider the effect of the determined price on the other party to the transaction. However, because operating expenses effect the calculations, the result for the transactional net margin method is likely to be less reliable than that determined under the other methods. It is important, therefore, to check that the profit resulting from applying the transactional net margin method is consistent with what one may expect, based on first principles.³⁰³

³⁰² Hardesty Transfer Pricing and E-commerce (2002) at 36.

³⁰³ SARS Practice Note 7 (1999) para 9.7.3.

4.5.3.2.2 The Profit Split Method

Description

The first step in the profit split method is to identify the combined profit to be split between the connected parties in a controlled transaction. In general, combined operating profit is used, ensuring that both income and expenses of the multinational are attributed to the relevant connected person consistently.

That profit is then split between the parties according to an economically valid basis approximating the division of profits that would have been anticipated and reflected in an agreement made at arm's length.³⁰⁴

Application

The profit split method is usually applied where transactions are so interrelated that they cannot be evaluated separately. Under similar circumstances, independent enterprises may decide to set up a form of partnership and agree to some form of profit split. Two alternative approaches to the profit split method are outlined in the OECD Guidelines.³⁰⁵ Under both approaches, the first step is to determine the combined profit attributable to the parties to the transaction. The combined profit is then allocated as follows:

- Under the residual profit split approach, each of the parties to the transaction is assigned a portion of profit split according to the basic functions that it performs. The residual profit or loss is then allocated between the parties on the basis of their relative economic contribution in respect of the amount to be allocated.

³⁰⁴ Ibid para 9.8.1.

³⁰⁵ OECD Transfer Pricing Guidelines (1995).

- Under the contribution analysis approach, it is generally the combined operating profit (profit before interest and tax) that is divided between the parties on the basis of the relative contribution of each party to that combined gross profit.

The allocation of gross profit should be consistent with the location of activities and risks. Care must be taken to ensure that the expenses incurred by or attributable to each enterprise are consistent with the activities performed and risks assumed by the relevant entities.³⁰⁶

Like all profit based methods the profit split method is less dependent on comparable uncontrolled transactions than the traditional methods. In the absence of reliable external data it can be adopted on the basis of a functional analysis of each party's contribution mainly taking into account the functions performed, risks borne and intangibles used.

On the other hand, the profit split method reveals some flaws. The profit to be split must be calculated uniformly to apply the profit split method. Unless tax authorities in each relevant taxing jurisdiction compute global profits on a consistent basis, it is almost certain that such profits will be subject to over (or under) taxation. The application of the profit split relies on access to worldwide group data, which may be difficult to obtain.³⁰⁷

As a result, the Transfer Pricing Guidelines stress that it may be difficult to measure combined revenue and costs for all the associated enterprises participating in the controlled transactions. In particular there are difficulties in identifying the appropriate operating expenses associated with the transactions³⁰⁸.

³⁰⁶ SARS Practice Note para 9.8.2.

³⁰⁷ SARS Practice Note 7 (1999) para 9.8.3.

³⁰⁸ Hoeren (1999) 36.

4.5.4 The Impact of the Different Transfer Pricing Methods on E-commerce

The impact of e-commerce places great pressure on the traditional and transactional methods of transfer pricing. The specifics of electronic commerce raises a number of problems when applying the traditional methods as different transactions are sometimes impossible to separate when one takes into account the speed and integration of electronic commerce. E-commerce enables multinational companies to exchange information instantaneously without having regard to physical boundaries. Since comparables are difficult to find in the context of electronic commerce, the application of the traditional methods are difficult to apply.³⁰⁹ As a result of integrated multinational cooperation, it is almost impossible to identify specific transactions to which traditional methods could apply.³¹⁰ Nonetheless the application of the traditional methods could apply where e-commerce is carried out at a less integrated level. In such cases, transactions and functions can be identified and properly rewarded.³¹¹

However, according to the Transfer Pricing Guidelines, it may be difficult to identify the expenses attributable even to a group of related transactions.³¹² The transactional net margin method underlies this problem as the combined expenses must be allocated to identify the proper net margin. The profits split methods, application of which is recommended by the OECD in integrated trading models,³¹³ are generally to be applied by combining and dividing the operation profits so that the expenses also have to be

³⁰⁹ Hoeren (1999) 36. See also Steef B 'E-commerce: A Transfer Pricing perspective' 1998 *Deventer* 86.

³¹⁰ OECD The Taxation of Global Trading of Financial Instruments (1999) para 116.

³¹¹ Hoeren (1999) 36.

³¹² OECD Transfer Pricing Guidelines (1995) para 1.42.

³¹³ *Ibid* para 3.9.

identified and attributed. As stated in the Guidelines,³¹⁴ it may be appropriate to carry out a split of gross profits and then deduct the expenses incurred in or attributable to each relevant enterprise. The latter method allows a less exact attribution of expenses and ensures that enquiries are necessary to check their deductibility in compliance with a jurisdiction's own tax rules. Nonetheless the identification of transaction related costs is still necessary.³¹⁵

Therefore, even the application of the profit methods to a group of transactions does not completely resolve problems that arise in determining related costs in highly integrated Internet trading activities.³¹⁶ Hoeren further states that the specific features of both methods render the application inappropriate in the environment of electronic commerce. With regard to the transactional net margin method, missing internal and third party comparables make it impossible to reliably achieve an arm's length result. When using the profit split method the same issue arises, at least when it is applied to gross profits. In addition, uniform calculation of the operating profit and the split factor must be achieved.³¹⁷ Under the current provisions, taxpayers and tax authorities still need to determine revenue and costs on a transactional basis that are attributable to each associated enterprise. This might be possible in practice if the taxpayer maintains a fine tuned accounting system. However, according to Hoeren whether the transactional net margin method or the profit split method can be applied depends then on the merits of each enterprise's situation.³¹⁸

³¹⁴ *ibid* paras 3.5 and 3.6.

³¹⁵ Hoeren (1999) 37.

³¹⁶ *Ibid.*

³¹⁷ *Ibid.*

³¹⁸ *Ibid.*

The OECDs' Committee on Fiscal Affairs has not issued any general transfer pricing guidelines for electronic commerce, although it appropriately points to the dangers of waiting too long to provide guidance for difficult transfer pricing issues from e-commerce. However, the United States is the only country that has introduced specific regulations³¹⁹ dealing with global trading of financial instruments, which provide some useful guidance for the treatment of other forms of electronic commerce. According to Doernberg,³²⁰ in the interim, national administrators may apply existing transfer pricing guidelines to e-commerce along the following lines. Where transactions over the Internet are not closely integrated and comparables are available,³²¹ it may be possible and appropriate to apply the traditional standard methods.³²² Where the e-commerce among specialized multinational enterprise undertakings is integrated and the performance unitary, the aggregation of continuous transactions may be the most appropriate approach and the application of transactional profit split method the most fitting valuation method. As in the case of global trading, the profit-split method may become a standard method for integrated electronic commerce rather than a last resort.³²³ The United States proposed regulations' application of the profit-split method to global dealing likewise contains potentially significant implications for electronic commerce. The profit split method evaluates whether the allocation of the combined operating profit or loss of a global dealing operation to one or more participants in the operation is at arm's length by reference to the relative value of each participant's contribution to the combined operating profit or loss.³²⁴ The relative value of each participant's contribution to the global trading activity must be determined in a manner that reflects the functions

319 Proposed Reg. § 1.482-8. See also Proposed Reg. §§ 1.475 (g)-2, 1.863-3(h).

320 Doernberg, Hinnekins, Hellerstein & Li (2001) 313.

321 For example, in many manufacturing, distribution and support activities.

322 The comparable uncontrolled method, resale price method and the cost plus method.

323 Doernberg, Hinnekins, Hellerstein & Li (2001) 313.

324 Proposed Reg. § 1.482 – 8(e)(1).

performed, risks assumed, and resources employed by each participant in the activity.³²⁵ The regulations specifically provide that, in appropriate cases, 'the participants may find that a multifactor formula most reliably measures the relative value of the contributions to the profitability of a global dealing operation.'³²⁶ Such an approach would seem to be equally relevant to many ventures involving electronic commerce.

According to Doernberg, in the absence of any specific transfer pricing rules for e-commerce, the OECD position on the treatment of global trading of financial instruments may provide some useful insight³²⁷. Traditional transfer pricing methods should apply if comparable uncontrolled prices are available. For highly integrated transactions, however, a more appropriate approach may be the profit split method. It would be applied on a case-by-case basis, determining the profit share of each branch or affiliate with the profit experience of independent traders and risk managers in similar circumstances. The profit split method may be the best approach, but leaves open the question of which factors and what weighting should be used to attribute income according to arm's length standards. The OECD Global Trading Report makes reference to IRS Notice 94-40³²⁸ which focuses on value, risk and activity measured by reference to the compensation paid to key support people or to the net present value of transactions executed at each of the trading locations. In the absence of consensus on the concrete application of this method and criteria of transactional profit splitting, the Report suggests that bilateral or multilateral Advanced Pricing Arrangements or bilateral mutual agreement procedures may provide the certainty needed by a taxpayer and by taxing authorities.

³²⁵ Proposed Reg. § 1.482 – 8(e)(2).

³²⁶ *Ibid.*

³²⁷ Doernberg, Hinnekins, Hellerstein & Li (2001) 319.

³²⁸ 1994 – 1 CB 351.

However, Horner and Owens expresses the similar concern, as the application of profit based methods should be more appropriate in the environment of global electronic commerce as they do not directly rely on closely comparable transactions.³²⁹ They further submit that there could be a softening of the transactional principle when applying the profit split method on the grounds of practicality.³³⁰

However, Hinnekens states that the issuance of specific guidelines cannot be expected soon in the absence of further study and international consensus. In the meantime, taxing authorities may apply existing transfer pricing guidelines to e-commerce based on the type of transaction conducted. Therefore, multinational enterprises should consider advanced pricing agreements (APAs). In making that decision, the following should be considered³³¹:

- the risk that the local tax authorities may not agree with the proposed transfer pricing method used;
- degree of risk of double taxation;
- level of transfer pricing expertise in the local tax office;
- past relationships with local auditors;
- audit history.

4.5.4 Intangible Properties

The difficulties in pricing tangible goods and services for tax purposes, have already been considered. Another critical feature of electronic commerce is the pervasive use of

³²⁹ Horner & Owens (1996) 521.

³³⁰ Ibid.

³³¹ Miller (2000) 37.

intangibles. An intangible is an asset that has value that is independent from the services of any person, and which derives its value not from its physical attributes but from its intellectual content or other intangible properties.³³² Pricing issues associated with intangibles is a very contentious area of transfer pricing, with quite detailed rules and is considered beyond the scope of this thesis. However, the key concepts will be highlighted. Intangibles such as goodwill, patents, copyrights, trademarks, etc play many roles in e-commerce. Some are integral parts of electronic business and some are exploited for extraordinary profits. Like tangible goods, if transactions prove to be comparable, the comparable uncontrolled price method can be used; under this method, an uncontrolled transaction involving intangibles must be comparable to a controlled transaction before it can be used as a benchmark to test the controlled transaction. Intangibles are comparable if they are used in connection with similar products or processes within the same general industry or market; and have similar profit potential.³³³

Using the comparable uncontrolled price method where comparables are in existence has distinct advantages because the price is set with an easily understandable method and is less prone to differences in opinion. However, where comparable transactions ordinarily do not exist, the pricing methods are difficult to apply and provide uncertain results. When the comparable uncontrolled price method cannot be used, transactions involving intangibles can be priced using the profit split method. In this method, the combined operating profit from exploitation of an intangible is allocated between the licensee and the licensor in the same manner that uncontrolled parties would allocate the profit, this allocation takes into account the functions performed, the assets used,

³³² Treasury Regulations para 1-482-4(b). See also Hardesty Transfer Pricing and E-commerce (2002) at 27.

³³³ Treasury Regulation § 1-482-4(c)(2)(iii).

and risks assumed by each party.³³⁴ Allocation of profits associated with intangibles is the most difficult area of transfer pricing, and the application of a thorough understanding of all the rules and the literature does not necessarily result in the correct answers. Hardesty draws a brilliant analogy of transfer pricing for intangibles relating to a music composition³³⁵

'music compositions are constructed from a complex set of rules and theories. Ultimately, however, it is up to the composer to put the rules together in such a way as to please an audience. There are objective criteria to measure the worth of a composition. Likewise, with arguments to support a fair transfer price, it is up to accountants, economists, and lawyers to convince tax authorities that a price is correct. There are no objective benchmarks against which to test pricing.'³³⁶

4.5.5 Conclusion

Following from the analysis of transfer pricing methods, it is apparent that the solution to taxing companies is not a quick fix and that profit splits seem to be the most feasible way to allocate taxes between companies at this present time. However, it is suggested that the OECD Guidelines provide more detail on what factors to consider in determining a suitable profit split. With international cooperation, a transfer pricing regime can be devised to meet the challenges posed by electronic commerce and preserve the tax bases for the countries involved.

The study of transfer pricing highlights the difficulties posed to governments, by electronic commerce, in implementing adequate tax laws to maintain an efficient all encompassing tax net. While the 'arm's length' principle has been accepted as the

³³⁴ OECD Transfer Pricing Guidelines (1995); Treasury Regulations § 1.482-6.

³³⁵ Hardesty Transfer Pricing and E-commerce (2002) 45.

³³⁶ Ibid.

international standard used to determine transfer prices, the application of this principle in electronic commerce is more difficult than in a less integrated business environment, however policy makers are aware of the inherent problems. As online trading matures, more information will become available against which to test intercompany pricing. Until such time, however, a common sense application of current regulations and business economics, must be adopted to err on the side of prudence, in calculating a fair transfer price, where the current difficulties experienced, will be remedied as the 'new age' economy becomes more established.

"What the mind dwells upon, it grows upon.

What the mind grows upon, we become."

Monksarn

CHAPTER 5

THE APPLICATION OF EXISTING INCOME TAX PRINCIPLES TO ELECTRONIC

TRADING

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The following e-commerce practical example considers the application of the existing income tax principles outlined in chapter 4 to income arising from electronic commerce transactions. In applying the existing tax principles, this section first analyses income tax issues under existing rules focusing on residence based issues, permanent establishment, controlled foreign companies, characterisation of income and transfer pricing. This section concludes with a consideration of possible approaches to the problems existing under the current law.

5.1 The facts:

Digigames (Pty) Ltd. (hereinafter referred to as 'the company') is a company which has an established trade and customer base that has traditionally sold its products only to people who visit its single location in Durban, South Africa. It has been registered and incorporated in South Africa. It has three directors, all of whom are South African residents.

The existing business of the company is the sale of computer software and hardware for entertainment purposes. The types of software sold are computer games and the compatible hardware items sold are joysticks, steering wheels, game pads, electronic skateboards, and laser guns. The company has in-house programmers that design and program software for sale. It only distributes this copyrighted software. However, trading has been limited to South Africa. Due to an extensive survey carried out by the marketing department overseas, it was discovered that there is a demand for the products sold in other countries.

The board of directors decided to change its business operations from a traditional 'bricks and mortar', to a 'clicks and mortar' business³³⁷ by establishing a web site in the name of the company and web advertising³³⁸ some of its merchandise on the 'virtual mall' (www.Digigames.net). The web site contains details and pictures of all the products sold and comprises information about the software products, their purpose and payment details, how to download purchased software and a trouble-shooting hotline. The products are available for sale to customers worldwide and as a direct result of these orders placed on their web site it has to export products. They are able to link their ordering system into the web site using a 'shopping basket' facility linked to several major credit card companies as payment providers.

The company maintains a single web page, stored on three servers³³⁹ situated in the United Kingdom and United States of America, all with identical content. The servers are fully automated.

The company expanded its operations and in addition to the products sold in the existing business environment markets further products. The company produces its own software, distributes it directly to the customers via the Internet, and specialises in developing software products specially tailored to the needs of emerging market economies.

³³⁷ A 'bricks and mortar' company is one that sells goods and services only at physical stores; it does not sell goods and services over the Internet. A 'clicks and mortar' company is one with physical stores as well as a web site that sells and/or services.

³³⁸ The process of advertising on the World Wide Web.

³³⁹ A computer, or a software package, that provides a specific kind of service to client software running on other computers.

The new products for sale are:

- Programming and designing of software;
- Software , image, sound and text updates;
- Sale of distribution rights for graphics, characters and logos used in the games distributed by the company.

The staff of the company are organised into three divisions:

- Product development,
- Sales and distribution and
- After-sales and trouble-shooting hotline.

All these divisions are linked via the Intranet.³⁴⁰ This enables the staff in different divisions and locations to work simultaneously on a particular product.

Since the move to the cyber world, the company has no physical head office. Communication is carried out by modern communication technologies such as e-mail³⁴¹ and video conferencing.³⁴² Board meetings are held by teleconference, video conference or in constantly changing locations. General meetings of shareholders are held by electronic discussion and voting software. The company's documents and financial records are all kept on computer disks, which are accessible through a Wide Area Network ('WAN') or the company's web site.

³⁴⁰ A private network that uses Internet-related technologies to provide services within an organization.

³⁴¹ Messages, usually text, sent from one person to another via computer.

³⁴² Videoconferencing is a live connection of two or more people using a combination of video, audio and data to communicate.

The company has moved its entire physical location to Geneva, Switzerland.³⁴³ The hardware and tangible products are manufactured in a factory situated in Switzerland. Design and programming of the software are also conducted here. However, there is constant on-line³⁴⁴ communication with programmers employed by the company that are situated in other countries where the company products are in huge demand. The operations of the business are fully automated. Switzerland facilitates an account for the company that is fully electronic i.e. all Internet transactions can be effected through the company's Internet banking account.

Due to the poor management and liquidation of 'Technical On-line Support Services' (hereinafter referred to as 'TOSS Ltd. '), the company acquires a 30 per cent share in TOSS Ltd. TOSS Ltd. was formed and established in South Africa and has its place of effective management in South Africa. In order for the company to diversify its operations, they decided to provide on-line technical support to complement its current business operations. TOSS Ltd. provides on-line technical assistance to all computer-based operations for the company, worldwide. The technical support includes installation advice, trouble-shooting information, on-line technical documentation, and communications via e-mail. In addition to the technical support, it provides TOSS Ltd.,

³⁴³ The OECD Harmful Tax Competition Report (1998) para 3.5 defines tax havens as a jurisdiction actively making itself available for avoidance of tax which would be otherwise be paid in relatively high tax countries. Switzerland, the Bahamas, the British Virgin Islands, and Channel Islands are examples of tax haven countries. They offer low or zero tax rates and duty-free import/export privileges to businesses and there are typically no transfers and capital gains taxes. They further offer high levels of banking and commercial secrecy, absence of exchange controls on foreign deposits and foreign currencies and modern communications facilities. Corporate registration in these countries is simple and low-cost, making it attractive to establish a permanent residence. The absence of tax treaties with other countries prevents other governments from compelling the tax haven country to disclose financial information about a business. Total discretion and punishment for unauthorized disclosures are contained in the bank legislation of many tax haven countries such as Switzerland's Article 47 of the 1934 Federal law relating to banks and savings institutions.

³⁴⁴ Currently connected to computer networks.

supplies goods to the South African market and on-sells these products in the local jurisdiction. All transactions between the company and TOSS Ltd. take place over the Internet. The agreement between the company and TOSS Ltd. is that all goods would be supplied at cost.

With regard to the management and shareholders there is no controlling voting rights to South Africa citizens.

The customer may utilise the company's on-line facilities in the following manner:

The customer selects an item from the company's online catalogue of tangible goods and orders the item electronically. The product is then delivered to the customer by a common carrier. The customer may further select an item from the online catalogue of software and other digital products and place an order for the product electronically. The digital product is downloaded onto the customer's hard disk or other non-temporary media. The customer makes payment by a credit card or electronic cash.³⁴⁵

5.2 The South African Tax Implications

This electronic commerce example focuses on the tax implications arising out of the activities of the company and TOSS Ltd. The issues for consideration are as follows:

- Is the company a resident of South Africa?
- Whether the provisions of section 9D are applicable?
- Does the company have a permanent establishment in South Africa?
- Is the income derived from the sale of computer hardware and software over the Internet taxable in South Africa?

³⁴⁵ Electronic money designed to be used over a network or stored on cards similar to credit cards. In South Africa electronic cash is not a form of legal tender in terms of s 17 of the Reserve Bank Act 90 of 1989.

- Do the transfer pricing provisions apply to the company and TOSS Ltd?

Each of these issues will be considered in turn.

5.3 Is the Company a Resident of South Africa?

If a company conducts transactions over the Internet, the South African Revenue Services recommends that the following information be furnished on any commercial web site owned by a South African resident, company, close corporation, or trust³⁴⁶:

- The company's e-mail and web site address;
- The name and e-mail address and web site addresses of major customers with whom you conducted business on the Internet;
- Disclose separately values of sales and purchases of goods and services, indicating whether they are from South African or foreign sources;
- If these transactions have not been incorporated in the annual financial statements, reasons should be submitted.

A resident for the purposes of the Income Tax Act is defined as any person other than a natural person, e.g. company, trust, or partnership if it.³⁴⁷

- Is incorporated, established or formed in the Republic;
- Has its place of effective management in the Republic.

However, a company with its entire equity share capital held by persons who are not residents or trusts of South Africa is excluded from being a resident. Such a company is

³⁴⁶ Paragraph 17.40 of the Income Tax information brochure issued with IT14 B tax return.

³⁴⁷ See para (b) of the definition of 'resident' in s 1 of the Income Tax Act 58 of 1962.

called an international headquarter company³⁴⁸. Also where any indirect interest of residents or of any trust in the equity share capital of the company does not exceed 5% in aggregate of its total equity share capital, and where 90%³⁴⁹ of the value of the assets of the company represents interests in the equity share capital and loan capital of its subsidiaries which are not residents and in which it holds a beneficial interest of at least 50%³⁵⁰.

5.3.1 Where the Company is Incorporated, Established, or Formed

The terms 'incorporated', 'established', or 'formed' are not defined in the Income Tax Act.³⁵¹ According to section 32 of the Companies Act,³⁵² a company is a resident in the Republic because of its formation and incorporation in the Republic, irrespective of where it is managed or where it carries on its business. The fact that a company establishes a place of business, opens a branch, or acquires immovable property in the Republic does not qualify the company as a resident. A company will be 'incorporated in the Republic' if it was registered by the Registrar of Companies.³⁵³

It is submitted that since the company shifted from a paper-based economy to a digitised, electronically based economy and its memorandum and articles of association are available on-line, the company is not formed or incorporated in South Africa.

³⁴⁸ Paragraph (b) of the definition of resident in s 1 of the Income Tax Act 58 of 1962.

³⁴⁹ The definition refers to "90% of the value of the assets". If the value exceeds 90% the requirement will be met.

³⁵⁰ See definition of international headquarter company in s 1 of the Income Tax Act 58 of 1962. This definition is effective as from 1 January 2001 and applies in respect of years of assessment commencing on or after that date.

³⁵¹ Income Tax Act 58 of 1962.

³⁵² Companies Act 61 of 1973.

³⁵³ In accordance with s 63 of the Companies Act 61 of 1973.

5.3.2 Where the Company has its Place of Effective Management

The Income Tax Act does not define the term 'place of effective management'. However, the South African Revenue Services has accordingly issued an Interpretation Note³⁵⁴ to assist with the interpretation and application of this term. The South African Revenue Services has stated that in determining the meaning of place of 'effective management', the following are distinguishable:

- The place where central management and control is carried out by a board of directors;
- The place where executive directors or senior management execute and implement the policy and strategic decisions made by the board of directors and make and implement day-to-day, regular or operational management and business activities;
- The place where the day-to-day business are carried out or conducted.³⁵⁵

Therefore, the place of effective management is the place where the policy and strategic decisions are made by board of directors and are executed and implemented on a regular day-to-day basis and this is determined irrespective of where the overriding control is exercised or where the board of directors meets. If these management functions are not executed at a single location due to the fact that directors and senior managers manage via distance communication the view is held that the place of effective management would best be reflected where day-to-day operational management and commercial decisions taken by the senior managers are actually implemented, in other words, the place where the business operations/activities are

³⁵⁴ SARS Interpretation Note No.6 as at 26 March 2002.

³⁵⁵ SARS Interpretation Note 6 (2002) para 3.1.

actually carried out or conducted.³⁵⁶ However, if the business operations/activities are conducted from various locations, one needs to determine the place with the strongest economic nexus. When determining the place of effective management, all relevant facts, and circumstances need to be taken into consideration. The following factors serve as a guideline in determining the place of effective management for persons other than natural persons³⁵⁷:

- Where the center of top level management is located;
- Location of and functions performed at the headquarters;
- Where the business operations are actually conducted;
- Where controlling shareholders make key management and commercial decisions in relation to the company;
- Legal factors such as the place of incorporation, formation or establishment, the location of the registered office or public officer;
- Where the directors or senior managers or the designated manager, who are responsible for the day-to-day management, reside;
- The frequency of the meetings of the entity's directors or senior managers and where they take place;
- The experience and skills of the directors, managers, trustees or designated managers who purport to manage the entity;
- The actual activities and physical location of senior employees;
- The scale of onshore as opposed to offshore operations;

³⁵⁶ Ibid para 3.3.

³⁵⁷ Ibid para 3.4.

- The nature of powers conferred upon representatives of the entity, the manner in which that power are exercised by the representatives and the purpose of conferring the powers to the representatives.

These factors are, however, not exhaustive or specific.

From the example quoted above, it is submitted that the business operations and activities take place in Switzerland. Important decisions are decentralised to the respective areas of operations. The board meetings take place over the Internet, and it does not have South Africa as a fixed place of business. Strategic business decisions are concluded on-line and take place outside South Africa. Therefore, the company does not have its place of effective management in South Africa, and would not be regarded as a 'resident' for the purposes of section 1 of the Income Tax Act.

5.2 Does the Company have a Permanent Establishment in South Africa?

In *SIR v Downing*³⁵⁸, the taxpayer previously a resident in South Africa emigrated to Switzerland. He entrusted his financial affairs and the management of his share portfolio to a broker in South Africa. His broker regularly and frequently made changes to the portfolio without reference to the taxpayer. The share portfolio increased in value and in holdings. The issue was whether the gains were exempt from tax in South Africa under the double tax agreement concluded by South Africa and Switzerland. Substantially the question was whether the taxpayer had carried on business in South Africa through a permanent establishment. Accordingly, it was held that the enterprise was not carrying on business in the Republic through a permanent establishment.

³⁵⁸ 1928 AD 207.

In *Transvaal Associated Hide and Skin Merchants (Pty) Ltd v Collector of Income Tax, Botswana*,³⁵⁹ Maisel JA held that the occupation by a company of a shed at a rental over a period of thirteen years established that the company's 'occupation of the premises was not temporary or occasional, but was permanent.'

In applying the existing rules to the example described above, it is submitted that the company has no fixed place of business through which the business enterprise is wholly or partly carried on. Its offices, place of management and factory are situated in Geneva, Switzerland. The web site is situated on servers that are located outside of South Africa i.e. United Kingdom and United States of America. Thus, it has no physical presence or permanent establishment in South Africa. Since the company does not have a permanent establishment in South Africa, it is unnecessary to determine what profits are subject to tax, as South Africa does not have the authority to tax business profits without a permanent establishment situated in South Africa.

5.3 Whether the Provisions of Section 9D are Applicable?

The purpose of controlled foreign companies is to prevent or limit the reduction, deferral, or avoidance of taxes through the use of controlled foreign companies set up in low tax jurisdictions.³⁶⁰ The ability of taxpayers to sell digitised information and services electronically may require a re-examination of the controlled foreign company provisions to see if they are sufficient in their current form to achieve their intended purpose.

If a South African vendor were to incorporate a web-based business in a tax haven, or a low tax jurisdiction, and ensures that the effective management of the company is not in

³⁵⁹29 SATC 97.

³⁶⁰ Doernberg, Hinnekens, Hellerstein & Li (2001) 320.

South Africa, it would escape tax in South Africa only if it were not caught by the controlled foreign company rules. These rules are also enforceable in foreign jurisdictions and, subject to certain exemptions, effectively regard the income earned by the so-called offshore company as attributable to and hence taxable in the hands of South African residents. Therefore section 9D is aimed at South African residents who may try to avoid South African tax on foreign income by placing their income earning activities in a foreign company. This, further effects taxing in the hands of South African directors or shareholders, the income of the foreign company if it is a controlled company as defined.

Clearly, in the e-commerce example above the directors of the company are residents of South Africa; however, the company has no place of effective management in South Africa and is therefore not a resident of South Africa. Thus, the company would escape tax in South Africa. However, would the company be within the controlled foreign company provisions governing income tax?

A foreign company means any person other than a natural person which has its place of effective management in a country other than South Africa. This includes a trust or a company, which is not a resident of South Africa. Thus, a controlled foreign company means any foreign company in which a resident or residents of the Republic, whether individually or jointly, hold more than 50% of the participation rights or are entitled to exercise more than 50% of the votes or control of such a company.³⁶¹ A participation right means the right to participate directly or indirectly in the capital or profits of, dividends declared by, or any other distribution or allocation made by the company.

³⁶¹ Section 9D (1) of the Income Tax Act 58 of 1962 sets out the definitions of 'controlled foreign company', 'foreign company,' and 'participation rights'.

The South African Revenue Services require the following information to be furnished for an interest held in a foreign company³⁶²:

- Name of the company and its country of registration and place of effective management;
- Organogram of how the interest in each foreign company is held;
- Nature of the business conducted by each foreign company;
- Copy of each foreign company's annual financial statements preferably prepared in accordance with the local requirement.

The controlled foreign company rules will not be applicable in the following circumstances³⁶³:

a) the income of a controlled foreign company will be imputed only to a resident who (together with any connected person in relation to that resident) holds in aggregate (and at all times during the foreign tax year) 10 per cent or more of the participation rights in the controlled foreign company and is entitled to exercise more than 10 per cent of the voting rights in the controlled foreign company. A connected person, in the case of an individual, would include any relative as well as any trust of which the individual or relative is a beneficiary. In the case of a company, it would include, amongst other things, its holding company, and subsidiary.

The amount imputed to a resident is an amount equal to the proportional amount of the net income of the controlled foreign company determined in the same ratio as the resident's participation rights to the total participation rights in the controlled foreign

³⁶² Paragraph 17.29 of the Income Tax information brochure IT 14 B.

³⁶³ Section 9D of the Income Tax act 58 of 1962.

company. The net income of the controlled foreign company is an amount equivalent to what its taxable income would have been if it had been a resident. The deductions and allowances of the controlled foreign company are limited to its income. Losses are carried forward to future years of assessment and are not imputed to the resident.

If more than 50 per cent of the shareholders in an offshore web-based company are residents, the income of the controlled foreign company will be imputed to them in proportion to their shareholding in the controlled foreign company, unless they satisfy the requirements of the 10 per cent rule mentioned above, or qualify under another exemption. The controlled foreign company rules will not apply if the income of the controlled foreign company was subject to tax in a designated country on a basis substantially the same as that of South Africa and at a statutory rate of tax of at least 27 per cent. The list of designated countries will include both treaty and non-treaty countries.³⁶⁴

b) Where the income of the controlled foreign company can be attributable to a business establishment of the controlled foreign company in a country other than South Africa.³⁶⁵

The definition of a business establishment is similar to that of a permanent establishment used in many double tax agreements. It has been defined to mean, amongst other things, a place of business with an office, shop, factory, warehouse, farm, or other

³⁶⁴ Algeria, Australia, Austria, Belgium, Canada, Croatia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Israel, Japan, Republic of Korea, Lesotho, Malawi, Namibia, Netherlands, Norway, Poland, Romania, Slovakia, Swaziland, Sweden, Thailand, Tunisia, United Kingdom, United States of America, Zambia and Zimbabwe.

³⁶⁵ See s 9D(9)(b) of the Income Tax Act.

structure which will be used by the controlled foreign company for a period of not less than a year.³⁶⁶ There are two further requirements:

- It must be suitably equipped with on-site operational management, employees, equipment and other facilities for the purpose of conducting the primary operations of the business,³⁶⁷ and
- The place of business must be utilised outside South Africa for a bona fide business purpose other than the avoidance, postponement or reduction of tax.³⁶⁸

The application of this exemption is restricted where the income of the controlled foreign company is derived from transactions conducted with connected persons who are residents.

It is extremely difficult for a web-based business³⁶⁹ that is a controlled foreign company to satisfy these requirements unless it:

- Establishes an office in the offshore jurisdiction;
- Located its server there;
- Employs people there to operate and maintain the server;
- Has a good commercial reason for locating its place of business there.³⁷⁰

A taxpayer who uses a fully automated web server located in a foreign jurisdiction will clearly not qualify for this exemption.³⁷¹ Such is one that displays products for sale, takes

³⁶⁶ Section 9D(1)(a)

³⁶⁷ Section 9D(1)(a)(i).

³⁶⁸ Section 9D(1)(a)(ii).

³⁶⁹ A single web-based business may operate from a server situated in a country, and allows for sales and/or sells intangibles that may be downloaded onto a customer's hard disk. Thus, this eliminates the need for offices and factory, and the employment of workers, due to the automated server.

³⁷⁰ Bagraim (2001) 35.

³⁷¹ Bagraim (2001) 36.

orders from customers, and arranges for delivery of the purchased product without human intervention.

Considering the application of these controlled foreign company principles to the e-commerce example set forth in section 5.1, it is submitted that the company will qualify for the exemption in section 9D(9)(b) for the following reasons:

- It has a business establishment in Geneva, Switzerland i.e. a factory that manufactures the goods, a warehouse that stores and dispatches the goods (place of effective management).
- It is suitably equipped with on-site operational management and employees i.e. there are programmers designing the software, as well as management personnel.
- The company has suitably equipped business premises with telephone, Internet, e-mail, and facsimile facilities.
- It has established a stable banking account at a banking institution in Geneva. The company carries on a bona fide business in Geneva.
- The server is operated in Geneva and is operated and maintained by personnel.

Therefore, the company satisfies all the requirements for the purposes of conducting the primary operations of such a business.

5.4 Is the Income Derived from the Sale of Computer Hardware and Software over the Internet taxable in South Africa?

The company earns income from the following e-commerce transactions:

1. The sale of hardware such as game pads, steering wheels, joysticks, laser guns and electronic skateboards (tangibles);
2. The sale of software designs and programs (intangibles);
3. The sale of the rights to distribute copyrighted material of a commercial game (commercial exploitation of the copyrights);
4. The provision of on-line technical services (customer support over a computer network).

Each of these transactions will be examined to establish the nature of income earned and their relevant tax treatment.

5.4.1 The Sale of Tangible Goods

The term 'goods' includes any incorporeal moveable thing, fixed property and any real right in any such thing or fixed property.³⁷² The sale of hardware such as game pads, steering wheels, joysticks, laser guns and electronic skateboards over the Internet constitutes the sale of goods and would therefore give rise to business profits in the company's hands. Goods ordered through the Internet will result in business profits under Article 7 of the OECD Model Tax Convention.³⁷³ This analysis assumes that the customer's rights acquired in the property are limited to personal use of the property. The transaction may result in either a sale or rental, depending on the rights in the property acquired by the customer.

³⁷² Section 31(1) of the Income Tax Act.

³⁷³ OECD Model Tax Treaty (2003).

In this case, once it is purchased, all risks and rewards are transferred to the customer, therefore it is a sale of goods and should be treated as business profits.

5.6.2 The Sale of Intangible Goods

Where the customer acquires a digital product, in this case software, image, sound, and text, for his own use, the transaction involves the acquisition of data. Since the customer does not acquire the right to use a copyright in a commercial sense (e.g. to reproduce and sell the copyrighted materials), the payment received by the company is not a royalty. While the act of copying the data may constitute the use of a copyright, the act of copying the material is not the main point of the transaction, and is not determinative of the character of the transaction. The act of copying digital material is merely incidental to the transaction, the substance of which is an acquisition of a copy of the copyrighted material itself.

In the e-commerce example described above, the sale of software images and sound updates is actually a copy of the copyrighted material to enable existing software owned by the customer to function more effectively. By obtaining this the customer does not have any rights to distribute the material for commercial gain, therefore the income received from this transaction cannot be classified as a royalty. The downloads are obtained for the customer's own use, and all risks and rewards relating to the transaction are transferred to the customer. Therefore this transaction will be regarded as a sale and the revenue will be treated as business profits.

5.6.3 Electronic Ordering and Downloading of Digital Products for Purposes of Commercial Exploitation of the Copyright

The purpose of this transaction is the commercial exploitation of a copyright. The method of acquiring the digital product (e.g. disk or by download) is not relevant to the

transaction. What is relevant is the acquisition by the customer of the right to copy and distribute (commercially exploit) the copyrighted material. Since the substance of this transaction is the acquisition of the right to copy and distribute copyrighted materials, payments may be considered royalties.

The income received by the company, from its customers, for downloading copyrighted images, logos and characters can be regarded as royalty income. The download of these items for commercial gain, results in an exploitation of the copyright, therefore the income received by the company for these transactions will be royalties.

5.6.4 Technical Support over a Computer Network

Where on-line technical support is provided, it is important to distinguish between the provision of 'know-how', which results in royalties and the provision of 'services'. On-line support provided by technicians may give rise to services of a technical nature, but on-line access to a trouble-shooting database, while still a service does not constitute services of a technical nature.

Applying these facts to the e-commerce example, in providing the on-line technical support to its customer, they are not imparting special knowledge and experience for their customer's own use but are merely rendering a service that results in business profits in accordance with article 7.³⁷⁴

In the case of royalties or know-how payments received by non-residents or by an external company from a deemed South African source, section 35 applies to subject the royalty to a 12% withholding tax. The tax is withheld by the person paying the royalty and is paid to South African Revenue Services.

³⁷⁴ OECD Model Tax Convention concerning software payments.

5.7 Do the Transfer Pricing Provisions Apply to the Company and TOSS Ltd?

In assessing the transfer pricing provisions applicable in the current issue, a starting point is the Income Tax Act.

Section 31 (2) of the Act states that:

- Where goods or services,
- are supplied or acquired,
- in terms of an 'international agreement' and
- The acquirer is a 'connected person' in relation to the supplier, and
- The price of the goods or services is not an arm's length price (i.e. market value in the circumstances).
- The commissioner for the South African Revenue Services may adjust the price to an 'arm's length price' in calculating the taxable income of the acquirer or supplier.

This section gives the Commissioner the power to adjust prices where he considers that the price is artificially too high or too low.

In order to examine the application of section 31(2), to the facts of the example, a breakdown must be done of the different components of the section.

The transaction between the company and TOSS Ltd, falls within the definition of goods and services. Goods are defined to include 'corporeal movable things, fixed property, and any real rights in any such things or fixed property.'³⁷⁵

The definition of services³⁷⁶ includes the following:

- Anything done;

³⁷⁵ Section 31(1) of the Income Tax Act 58 of 1962.

³⁷⁶ Ibid.

- Anything to be done;
- The granting, assignment, cession, or surrender of any right, benefit or privilege;
- The making available of any facility or advantage.

In the example described above, it is submitted that the supply of computer accessories by the company to TOSS Ltd. would constitute 'goods' for the purposes of section 31 of the Income Tax Act because they qualify as 'corporeal moveable things'. It is further submitted that the technical on-line assistance provided by TOSS Ltd. falls within the definition of services in terms of section 31, as it relates to the 'making available' of a facility.

The next component to focus upon is the 'international agreement.' An international agreement is defined in the Income Tax Act³⁷⁷ to include the following:

'a transaction, operation, or scheme entered into by a person (other than a natural person) managed or controlled in the Republic and a person (other than a natural person) managed or controlled outside the Republic for the supply of goods and services to or by a permanent establishment of either of such persons outside the Republic.'

In Practice Note 7, guidance is given on the concept of 'managed or controlled', in order to determine the place where an entity is managed or controlled, regard will be given to the business activities of the entity and business activities of connected persons, as well as the degree of autonomy under which the entity operates.³⁷⁸

³⁷⁷ Section 31(2) of the Income Tax Act 58 of 1962.

³⁷⁸ SARS Practise Note 7 (1999) para 1.1.3.

The South African Revenue Services' view is that the control of an entity is to be found at the meeting place of the persons who exercise authority over and control the direction of the entity's business operations. A company is generally controlled by its directors. However, situations may be encountered where control is effectively exercised by the directors of company's holding company or ultimate holding company. The question where the shareholders may reside or meet in the annual general meeting (in the case of a company) is therefore irrelevant. The place where directors and other persons performing the same functions (in the case of entities other than companies) usually exercise their functions and direct the affairs of the entity is an indication of where an entity is controlled. In most cases this will be the place where the entity's head office is located. The place where an entity is managed is usually the place where the day-to-day running of the business activities takes place.³⁷⁹ From the above it is evident that the place from which an entity is controlled is not necessarily the place from which it is managed.

It has already been confirmed that the company has its residence on the Internet, with a permanent establishment in Switzerland, while TOSS Ltd. is effectively managed and controlled in South Africa. From an examination of the facts and an application of the provisions, it is submitted that the business dealings between the two companies results in an international agreement as defined.

The next issue to consider is whether the two companies are 'connected persons.' Practice Note 7 states that a connected person in relation to a company includes 'any other company, if at least 20 per cent of the equity share capital of such company is held

³⁷⁹ Ibid.

by such other company and no shareholder holds the majority voting rights of such company.³⁸⁰

Clearly in terms of this provision, the company and TOSS Ltd. are connected persons as the company has a 30 per cent interest in TOSS Ltd. and no other shareholder holds the majority voting rights in TOSS Ltd.

The South African Revenue Services requires the following information in respect of transactions with connected persons:

- Copy of the agreement entered into;
- Copy of the transfer pricing policy document;
- Original cost price of the asset to the connected person and current market value;
- Income tax value to the connected person on the date of the transaction.

The overriding principle in transfer pricing is that transactions between connected persons are to be connected at 'arm's length'. In the e-commerce example there are two separate transactions to focus on, firstly the provision of services by TOSS Ltd. to all the company's clients and secondly the supply of goods to TOSS Ltd. by the company for the sale in the South African market.

In the first instance, the issue for consideration is the income received by TOSS Ltd. for the provision that may be applied to determine if the income received for the service is market related. The source of income should be investigated, e.g.:

1. Do clients pay TOSS Ltd. directly?

³⁸⁰ Ibid para 1.4.5 (iv).

2. Does the price of products sold by the company include on-line assistance?
3. The company pays TOSS Ltd. a set monthly fee.

Each of the scenarios will result in a different application of pricing rules and a different interpretation of an 'arm's length' price. In scenario one, all income is received directly by TOSS Ltd. and no third party influence affects the income received, therefore this is an uncontrolled transaction and it can be concluded that the 'arm's length' principle has been achieved.

The second scenario is more complicated and requires a more thorough examination of the rules. It is suggested that a reliable comparable company be found, which provides a similar service and the service that is performed should be valued. In evaluating such comparables, value should be attributed to factors such as the provision of human labour, use of assets, and technical know-how and assumption of risks. Due to the increasing trend in these types of services a similar comparable company would not be difficult to locate. It is submitted, therefore, that the comparable uncontrolled price method should be used to calculate an arm's length price. The income received for the services performed by TOSS Ltd. should be market related, and should be a fair compensation for the work performed.

The rules of the second scenario can be applied to the third scenario. However, in this case the profit-split method may also be a useful way of apportioning income between the companies. The important concept in applying the profit-split methodology is the necessity to value the activities performed by each party. The value of the services performed by TOSS Ltd. can be calculated by examining a comparable company, therefore it is submitted in this instance that the comparable uncontrolled price method seems to be the most feasible method of valuing the transaction.

The supply of goods to TOSS Ltd. for the sale in the local market is the next issue that needs to be resolved. In this case, goods are supplied at cost to TOSS Ltd. and the market price of the same goods is clearly determined. The problem that arises is how much of the profit from the sale is routed back to the company. A major concern with routing profits back to Switzerland is the erosion of the local tax base. What needs to be considered is how TOSS Ltd. is compensated for facilitating the local market if the profits earned are entirely attributable to TOSS Ltd., and then the Commissioner must consider that the transaction was not conducted at 'arm's length' and may choose to adjust the price to reflect a fair market price. If the profits are routed in its entirety to the company, and TOSS Ltd. only receives a commission for their sale, the Commissioner may adjust the price to an arm's length price in calculating the taxable income of TOSS Ltd. In addition, the adjusted amount may be subject to section 64C³⁸¹ and treated as deemed dividend paid by TOSS Ltd. to the company. This would result in an additional tax liability for secondary tax on companies. The transfer pricing provisions are applied to ensure the stability of our tax base, and the consistency in taxing income and profits that are rightly earned in South Africa.

From a comprehensive analysis of the components that make up section 31, it can be concluded that the transactions between the two companies do fall within the ambit of this section, and can come under scrutiny of the Commissioner.

³⁸¹ Of the Income Tax 58 of 1962.

5.8 Conclusion

Applying the current South African tax rules to the e-commerce practical example described above, it is submitted that:

- The Company will not be taxable in South Africa as it is not a resident due to the fact that the place of effective management is outside of South Africa and it is not formed, established or incorporated in South Africa;
- The Company has no permanent establishment in South Africa;
- The Company is not a controlled foreign company as defined and therefore, the provisions of section 9D are not applicable;
- The Company earns business profits and royalty income from their operations, however, for the reasons set out above this income would be subject to tax in South Africa;
- TOSS Ltd. is a connected person to the Company and the transactions between these two companies fall within the ambit of section 31.

The above example illustrates the inherent simplicity for a company with the advent of the digital economy to manipulate the traditional rules governing taxation and minimise its tax liability. Sustained manipulation of these tax rules would eventually result in the tax base of South Africa being eroded. Thus, the growth of e-commerce forces a re-evaluation of the tax rules discussed above, without comprising the basic principles of neutrality and consistency. It is suggested that the South African Revenue Services consider implementing stricter controlled foreign company provisions and focusing on extravagant tax havens to combat the manipulation of these provisions, by adopting this recommendation the tax system would benefit twofold, viz, by enhancing both the traditional and electronic forms of commerce.

The following represent some possible approaches to the issues raised by electronic commerce that the South African Revenue Services may consider.

A possible approach to the taxation of profits from electronic commerce is to re-invent or re-source the permanent establishment concept and look for a permanent establishment fiction, e.g. a virtual permanent establishment.³⁸² As seen in chapter 3 this 'virtual permanent establishment' approach raises a number of criticisms and this approach needs further development.

As electronic trade becomes more common, consumers will want a definite address where they may submit complaints, correspondence, or payments. Having an 'address of incorporation' would provide such a location. Therefore, every web page should include an address and that location should be used for residence-based taxation purposes.³⁸³ However, a problem with this approach is that companies would locate to no or low tax jurisdictions.

Another possibility to the problem of corporate residence would be to base a company's residence on the residence of its directors or managers, or the residence of a specified number or percentage of its shareholders or employees. Unlike the 'place of effective management', this test focuses on where the decision-makers actually reside rather than where the decisions are made.³⁸⁴

³⁸² Doernberg, Hinnekens, Hellerstein & Li (2001) 346.

³⁸³ Ibid.

³⁸⁴ Ibid 376.

Alternatively, if international consensus could be reached on a formula for allocating income, then there would be no need to determine residence.³⁸⁵ All income would be allocated based on a formula. The formula might take into account location of company property, place of incorporation, sales, payroll, or other factors. This test attempts to quantify these factors resulting in an objective rather than a subjective test. However, the formulary appointment has also been suggested to replace the arm's length method of transfer pricing.

A possible approach to the problem of characterisation of income is to characterise income from electronic commerce into 'digital income' (income from digital transactions) and 'non-digital income' (income from electronic commerce transactions involving the physical delivery of goods).³⁸⁶ However, it is submitted that this approach defeats the OECD principles of neutrality.

³⁸⁵ Ibid.

³⁸⁶ Ibid 378, see also Li J 'Rethinking Canada's Source Rules in the Age of Electronic Commerce' (1999) 47 *Canadian Tax Journal* 1411.

CHAPTER 6
CONCLUSION

The previous chapters of this thesis discuss electronic commerce and the concept of the Internet, the reaction of governments and organisations, the problems created by e-commerce, the existing framework of income tax, an analysis of the application of existing rules to e-commerce transactions and possible approaches to e-commerce. This section concludes with general observations on the process of reevaluating tax systems in light of e-commerce developments.

Electronic commerce is revolutionizing business culture and economies worldwide. Through e-commerce, businesses have been presented with considerable growth opportunities and substantial increases in profit. However, e-commerce has proved to be equally detrimental, by challenging existing tax rules, thereby forcing a re-examination of the existing tax framework. Uncertain and inconsistent application of the existing tax rules to e-commerce or the inadequacy of national or international legislation or tax treaties will lead to double or non taxation and an erosion of the tax base. E-commerce is a global challenge that requires international cooperation and consensus. The governments and tax authorities worldwide have been tasked with developing a tax framework for e-commerce based on common principles of: neutrality, efficiency, certainty and simplicity, effectiveness and fairness, and flexibility. It is submitted that institutional thinking should strive to develop an international accepted, uniform, and workable tax framework whilst at the same time, encouraging progress in the electronic age and ensuring that a fiscal sovereignty is preserved.

The following issues should be considered in achieving the above tax system:

Source versus residence: for a residence-based system to function smoothly there would have to be international consensus concerning the definition of residence and how it is determined in multi-jurisdictions.

Double tax agreements: Improvements should be made in the use of existing bilateral and multilateral agreements.

Permanent establishment: a conclusion is needed as to whether the existing rules of permanent establishment are applicable to e-commerce or whether a change is needed.

Broadening the definition of permanent establishment to include servers, web pages, or software agents would leave the taxpayer subject to tax in multiple jurisdictions. Thus consensus should be reached on whether levels of economic activity or physical presence be used as a criteria for permanent establishment in the electronic age.

Characterisation of income: the dividing line between royalty and sales income should be clarified, regardless of the electronic era.

Transfer pricing: the application of the OECD transfer pricing guidelines should be monitored for developments and the principle of transfer pricing be retained, but updated.

For the moment a re-examination, re-evaluation and further study and development is needed for the taxation of electronic commerce rather than a whole new system of taxation.

Electronic commerce and globalisation are, and will continue to be a challenge to tax authorities throughout the world. The 'art of taxation,' advised Louis XIV's treasurer, Jean Babtiste Colbert, 'consists in so plucking the goose to obtain the largest amounts of feathers, with the least possible amount of hissing. Today, the problem lies in not

obtaining the most feathers but in getting hold of any at all. In fact, the real problem is getting hold of the goose: ... geese have gone virtual.³⁸⁷

"I have not failed 10, 000 times. I have successfully found 10, 000 ways that will work."

Thomas Edison

³⁸⁷ Ter Weel (1999).

APPENDIX

Typical Language of a Permanent Establishment

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

2. The term “permanent establishment” shall include especially:

(a) a place of management,

(b) a branch,

(c) an office,

(d) a factory,

(e) a workshop,

(f) a mine, quarry, or other place of extraction of natural resources,

(g) a building site or construction or assembly project which exists for more than twelve months.

3. The term “permanent establishment” shall not be deemed to include:

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

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

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

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

(e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise.

4. A person acting in a Contracting State on behalf of an enterprise of the other Contracting State - other than an agent of an independent status to whom paragraph 5 applies - shall be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise.

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

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

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