

# The VAT implications of e-commerce goods and services imported to South Africa

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## **Abstract**

**TITLE:** The VAT implications of e-commerce goods and services imported to South Africa

**KEYWORDS:** Foreign suppliers, digital services, e-commerce, value added tax

This research identified that e-commerce is growing annually and has a significant impact on the South African economy. When the Minister of Finance announced that VAT registration would become compulsory for foreign suppliers importing e-commerce transactions into South Africa, there were many speculations regarding the implication this will have for South Africa.

The main objectives for the research are to determine whether the current VAT structure and VAT Act in South Africa will be able to support the proposal made by the Minister of Finance and what possible challenges should be considered regarding VAT on e-commerce transactions that were already identified by other countries. It will further be considered whether the proposal is in line with current international legislation and trends.

Therefore, the development and implementation of VAT on e-commerce transactions in the European Union and New Zealand were researched and discussed to obtain an understanding of the similar current VAT systems in other parts of the world. It was identified during the research that there are still challenges experienced with the implementation of VAT on e-commerce transactions. The challenges range from the anonymity of the parties to the identification of the permanent establishment of the supplier, which are discussed in detail. These challenges can lead to tax evasion and the erosion of a country's revenue base. The proposal by the Minister of Finance is found to be in line with other countries' implementation of VAT on e-commerce transactions.

Furthermore, South Africa's current VAT system was analysed to ascertain whether it is sufficient to implement VAT on e-commerce transactions. Currently, SARS is dependent on the consumer's honesty to declare the VAT on all e-commerce transactions.

It was further identified that there are challenges relating to the implementation of VAT on e-commerce transactions as it is lacking place of supply rules, which often creates uncertainty about whether a product is subject to VAT.

It was found in the study that the current VAT system would not be sufficient to support the proposal made by the Minister of Finance without an amendment to the VAT system to secure the income from the consumption tax on e-commerce transactions. It was further found that there are worldwide still challenges experienced with the implementation of VAT on e-commerce transactions. Recommendations were made for further research relating to the new Tax Bill that is due to be released in 2014 and the impact it will have on the South African economy.

## Opsomming

**TITEL:** Die BTW-gevolge van ingevoerde e-handelgoedere en -dienste na Suid-Afrika

**SLEUTELWOORDE:** Buitelandse verskaffers, digitale-dienste, e-handel, belasting op toegevoegde waarde

Die navorsing het geïdentifiseer dat e-handel jaarliks groei en dat dit 'n wesenlike impak op die Suid-Afrikaanse ekonomie het. Die Minister van Finansies se aankondiging dat buitelandse verskaffers wat e-handel met Suid-Afrika bedryf, verplig sal wees om vir BTW te registreer, het spekulasies oor die effek in Suid-Afrika tot gevolg gehad.

Die hoofdoelstelling van die navorsing is om te bepaal of die huidige BTW-stelsel en wetgewing in Suid-Afrika in staat sal wees om die aankondiging van die Minister van Finansies te ondersteun, asook om moontlike uitdagings te ondersoek wat gepaard gaan met die implementering van BTW op e-handel transaksies, soos reeds deur ander lande geïdentifiseer is. Ondersoek is ook ingestel om te bepaal of die aankondiging in lyn is met die huidige internasionale wetgewing en neigings.

Die ontwikkeling en implementering van BTW op e-handel in die Europese Unie en Nieu-Seeland is ondersoek om 'n beter begrip van soortgelyke huidige BTW-stelsels in ander dele van die wêreld te verkry. Tydens dié navorsing is daar geïdentifiseer dat daar nog uitdagings ondervind word met die implementering van BTW op e-handel. Die uitdagings wat in detail bespreek is, wissel van die anonimiteit van die betrokke partye tot die identifisering van die permanente saak van die verskaffer. Hierdie uitdagings kan lei tot belastingontduiking en die erosie van die land se inkomstebasis. Die aankondiging van die Minister van Finansies is in lyn met ander lande se implementering van BTW op e-handel.

Suid-Afrika se huidige BTW-stelsel is verder ontleed om te bepaal of dit voldoende is om die implementering van BTW op e-handel te ondersteun. Tans is die SAID afhanklik van die gebruiker se eerlikheid om die BTW op alle e-handel te verklaar.

Verder is daar geïdentifiseer dat daar uitdagings is wat verband hou met die tekort aan “plek van lewering”-reëls. Dit veroorsaak onsekerheid of ’n produk aan BTW onderhewig sal wees, al dan nie.

Die gevolgtrekking van die navorsing is dat die huidige BTW-stelsel nie voldoende is om die aankondiging van die Minister van Finansies te ondersteun sonder aanpassings aan die BTW-stelsel nie. Verder is gevind dat daar nog wêreldwyd uitdagings ondervind word met die implementering van BTW op e-handel. ‘n Aanbeveling is gemaak dat verdere navorsing onderneem moet word om die nuwe Belasting Regulasie wat in 2014 geïmplementeer word, te ondersoek, sowel as die impak wat dit op die Suid-Afrikaanse ekonomie kan hê.

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## **Chapter 1     Introduction**

### **1.1.     Introduction**

#### **1.1.1.     Background to the research area**

When e-commerce started in the early 1990s, no-one expected the growth explosion it experienced in the latter part of the decade (Boeth, s.a.). E-commerce is one of the fastest growing retail sectors in the global economy. There is no question that e-commerce is here to stay as an integral component to a successful retail sales strategy (Bank of America, 2012). Looking forward, there is no indications that this sector supported by high technological progress will ever slow down (Belousova, 2010). The potential for e-commerce transactions to gain a sizeable share of consumer and business purchases appears to be large, although it is difficult to quantify (OECD, 2000a).

E-commerce is a generic term to describe the technology, processing and operations that occur when business or financial transactions are conducted by electronic means (Van der Merwe, 2003). Tax problems are primarily caused by electronic commerce transactions when they cross boundaries between taxing jurisdictions (McLure, 2003).

In the debate in the European Union on The Value Added Tax (VAT) Policy it was focused on how best to extend the existing tax system to e-commerce transactions in the form of digitised products (Zodrow, 2003). The first attempts to establish the European Union's rules on taxation of Internet transactions were made by the Council Directive 2002/38/EC on 7 May 2002 (European Commission, 2002), which was passed in line with the principles of e-commerce taxation developed by the Organisation for Economic Co-operation and Development (OECD) (OECD, 1998).

The Council Directive introduced additional measures necessary for the registration of e-service traders for VAT purposes not established within the community and for distributing the VAT receipts to the member states of the European Union where the

services were used. These principles establish that the rules for consumption taxes (such as VAT) should result in taxation in the jurisdiction where consumption takes place (Anon, 2013). These measures mean that the EU became the first significant tax jurisdiction in the world to develop and implement a simplified framework for consumption taxes on e-services in accordance with the principles agreed within the framework of the OECD (Anon, 2013).

Following the international trend to create a taxation system for e-commerce applicable to the European Union and other countries, the Minister of Finance, Pravin Gordhan, announced in the 2013 Budget Speech that all foreign businesses supplying e-commerce in South Africa will be required to register as VAT vendors (Nel, 2013).

#### **1.1.2. Literature review of the research area**

The European Union is still experiencing problems after the implementation of VAT on e-commerce within the VAT structure and laws. Amendments have been made since the first implementation while creating the perfect system.

While no statistical studies have been found on the ensuing loss of revenue, it may prove to be a large loss for South Africa and for other jurisdictions globally. Furthermore, complexities also exist in respect of supplies between businesses, between businesses and governments, and a combination of these, which, if left unaddressed, will lead to a loss either to government revenue or to double taxation. This hinders globalisation and affects South Africa's global economic position in this new virtual world (Bardopoulos, 2013).

Many observers have noted that there are complex tax administration issues raised by this relatively new form of commerce, especially those associated with the sale of digitised content (McLure, 1997).

One of the primary problems experienced with e-commerce is that when an order is placed through the Internet, it may be difficult to identify and locate the parties to the transaction, especially if the customer is a private consumer (Van der Merwe, 2003). Changing the authorisation process in order to verify an address for tax purposes would require altering fundamental business policies and protections, which could lead to considerable system modifications at significant costs to the credit card industry. These changes would not only affect card issuers and cardholders, but they would also require changes in systems for card associations, merchant banks and other transaction facilitators (TAG, 2000).

When comparing the main characteristics of South Africa's VAT system to the European VAT system, one notices that both systems are a consumption tax levied at all stages throughout the production chain based on a system of output less input. This distinguishes the South African and European VAT systems from the US sales and use taxes, which only charge the final consumers when goods are supplied (Schenk & Oldman, 2007). In September 1991, South Africa replaced its general sales tax (GST) with a consumption-type VAT (Go, Kearney, Robison & Thierfelder, 2005). It is an indirect tax based on consumption in the economy (SARS, 2012).

Many countries apply a form of indirect or consumption taxes such as VAT, and although these tax systems might be known by different names, the characteristics of the tax are normally quite similar. The generally accepted essential characteristics of a VAT-type tax are as follows:

- The tax applies generally to transactions related to goods and services.
- It is proportional to the price charged for the goods and services.
- It is charged at each stage of the production and distribution process.

The taxable person (vendor) may claim the tax paid during the preceding stages (that is, the burden of the tax is on the final consumer) (SARS, 2012).

Because the VAT system of the European Union is similar to the South African VAT system, the European Union VAT system will be used as a base for the research on how to develop a VAT system for e-commerce for South Africa. Another country identified with a similar VAT system is New Zealand. New Zealand's VAT system will be included in the research for further considerations of how VAT can be implemented on e-commerce transactions in South African context.

In South Africa, the consumer bears the burden of VAT; however, the VAT Act requires vendors to register with the South African Revenue Service (SARS), collect VAT and pay the VAT to SARS. For foreign companies providing goods and services in South Africa, it was not required to register for VAT purposes in the past because VAT was still levied on the goods and services by customs at the border post; however, with the importation of e-commerce, this is not the case (Ernst & Young, 2013).

South Africans can download e-commerce from the Internet from any supplier around the world. Based on section 14(1) of the VAT Act, the recipient of imported services has the responsibility to pay the VAT to SARS, because, with imported e-commerce, there is no border post or post office that can perform the function as collecting agents (National Treasury, 2013). SARS is therefore depending on the tax honesty of the recipient and this system lacks enforceability because no evidence exists as to which consumer bought e-commerce originating from a source outside South Africa.

The loss of tax contributions and the lack of enforceability of the current system have led to the announcement of the registration of foreign businesses for VAT to avoid a loss in revenue for SARS.

### **1.1.3. Motivation of topic actuality**

Currently, there are no published rulings, tax court decisions, and relevant publications or interpretation notes focusing on the VAT treatment of electronic commerce transactions in South Africa. Even though the existing VAT legislation is applicable in certain circumstances, the legislation will not be able to achieve a proper functioning of the VAT system as SARS may stumble upon the practical difficulties of compliance and enforcement leading to a misallocation of VAT revenue and the non-taxation of certain transactions. The VAT implications of e-commerce transactions are definitely an area that requires proper guidance by SARS (Naicker, 2010).

VAT is one of the most important systems of taxation for the government of South Africa and the South African government continues to be excited at the prospect of VAT's ability to generate large amounts of tax revenue at an extremely low cost (PATC, 2013).

In the Green Paper on E-commerce, a consultative document on the government policy formulation process on e-commerce, it was pointed out that the legal framework in South Africa is currently insufficient to deal with e-commerce issues. The current legislation was tailored for paper-based commercial transactions, and there was therefore a need to formulate a new legal framework that includes those transactions that are conducted electronically (Oguttu, 2009).

While the approach of the EU might work because VAT laws are relatively harmonised, it could hardly be regarded as the international standard. Without substantial uniformity of VAT applicable in various countries, it is unreasonable to expect non-resident vendors to comply with the diverse VAT laws of more than 100 countries (McLure, 2003).

The Commission of the European Communities (2000) has indicated that, "E-commerce is, by its nature, a truly global process and no tax jurisdiction, acting in isolation, can resolve all the issues it raises.

The successful administration and application of taxes will to a great extent depend on, inter alia, achieving an international consensus...” (McLure, 2003).

As the information revolution continues to take the world economy by storm, tax principles and systems of tax administration will have to keep up with the changes (Steyn, 2010).

## **1.2. Research Question**

The current VAT Act and structures need to be evaluated to determine whether it is feasible to accommodate the proposal made by the Minister of Finance. Based on the current VAT Act, the registration for VAT does not create any complications, but by implementing the proposal of the Minister of Finance, difficulties may arise in the collection of VAT and complying with the new regulations. This research will therefore mainly focus on the proposal made by the Minister of Finance.

With the import of goods, border posts are responsible for the collection of the VAT. However, with the importation of services it will be more difficult to trace all the imported services used in South Africa. There will be complications to get all medium and small foreign companies to comply with this new requirement from the South African government.

The following research questions will be applicable in this dissertation:

- Are the VAT structure and VAT Act of South Africa sufficient to support the implications of importation of e-commerce?
- What challenges should South Africa consider when amending the current VAT structure and VAT Act to support the above proposal based on other countries' implementation of VAT on e-commerce transactions?

### **1.3. Objectives**

The main objectives of this research are to determine whether the current VAT structure and VAT Act in South Africa will be able to support the proposal made by the Minister of Finance and what possible challenges should be considered relating to VAT on e-commerce transactions that has already been identified by other countries.

As mentioned above, there are currently no published rulings, relevant publications or interpretation notes focusing on the VAT treatment of e-commerce in South Africa (Naicker, 2010).

To address the research questions, an investigation will be conducted on the VAT structure that is in place in the European Union and other countries by analysing and comparing the structure with the current VAT system in South Africa.

A further analysis will be performed on the problems experienced by the European Union and other countries that have amended and implemented VAT on e-commerce in their VAT systems.

An analysis of the current VAT structure in South Africa is needed on how e-commerce is currently treated as well as an interpretation of the VAT Act relating to e-commerce transactions.

One will then be able to conclude as to what the possible problems are that need to be considered if VAT on e-commerce transactions is implemented in South Africa and whether the current South African VAT system is sufficient to support the proposal by the Minister of Finance.



#### **1.4. Hypothesis**

The current VAT system will not be sufficient to support the proposal made by the Minister of Finance and problems are currently experienced with VAT on e-commerce.

Changes will have to be implemented in the current VAT system based on how other countries have implemented VAT on e-commerce in their VAT systems.

#### **1.5. Research design**

The research will be an applied descriptive research. Applied research is usually conducted to solve specific, practical questions and when conducted through descriptive research, it is attempted to describe systematically the situation or problem. The research will furthermore be extended to exploratory research and will be qualitative in nature. Exploratory research is usually undertaken to explore an area where little is known.

The reason for the chosen research method is because, for this research, there is a specific research question that needs to be answered and, to make a conclusion on the question, a systematic analysis of the current VAT system, the European and other countries' VAT system and problems experienced will be needed. Furthermore, exploratory research will be conducted because, in South Africa, no published rulings, relevant publication or interpretation notes focusing on the VAT treatment of e-commerce are available.

The method of data collection for the research will be secondary data, in other words, journal articles on VAT legislation in other countries, dissertations, and reports published previously on the related topic will be used, analysed and compared.

The main research objectives will be achieved by performing a literature review to understand the current VAT system and VAT Act in South Africa and drawing a conclusion on whether the VAT system in South Africa is sufficient.

Further, an understanding will be obtained from the European Union and other countries VAT systems by comparing it to the South African VAT system. Current problems experienced in the European Union and other countries will be analysed to gain an understanding of how it can be avoided in South Africa.

## **1.6. Chapter overview**

### **1.6.1. Chapter 1**

#### **Introduction, background, research question & objectives, research methodology**

The objective of this chapter is to determine the research question and research objectives that the study has to achieve. In addition, the research methodology for the remainder of the study will be established.

### **1.6.2. Chapter 2**

#### **The definition of E-commerce**

The objective of this chapter is to understand the general definition of e-commerce and what type of transaction will be regarded as an e-commerce transaction. Different models created to define e-commerce transactions will be analysed and compared to obtain a general understanding of e-commerce transactions and the different elements of an e-commerce transaction. A comparison will be drawn between how the European Union, New Zealand, the OECD, and South Africa are defining e-commerce transactions to create a focus and basis for this research. Furthermore, it will be considered whether direct e-commerce transactions or indirect e-commerce transactions will be the focus of the research. It will also be analysed whether e-commerce transactions will be considered services or goods in terms of the current South African tax legislation.

### **1.6.3. Chapter 3**

#### **VAT in the European Union and elsewhere**

The objective is to understand how the European Union and other countries, for instance New Zealand, have implemented VAT on e-commerce in their current VAT systems. Furthermore, the OECD has created a framework for VAT on e-commerce transactions. This framework will be discussed and compared to the implementation of VAT on e-commerce transactions implemented in Europe and other countries. By obtaining a better understanding of the VAT on e-commerce in the European Union and elsewhere, more knowledge will be available on how to implement VAT on e-commerce in South Africa.

### **1.6.4. Chapter 4**

#### **Challenges concerning VAT on e-commerce**

The objective of this chapter is to research and analyse the challenges experienced by the implementation of VAT on e-commerce in the European Union and other countries. This is done in order to highlight specific challenges experienced by other countries in order to help South Africa with the implementation of the Minister of Finance's proposal.

### **1.6.5. Chapter 5**

#### **VAT in South Africa**

The objective of this chapter is to understand how the legislation and VAT system in South Africa are currently operating and to highlight what weaknesses exist in the current VAT legislation relating to e-commerce transactions. This objective aims to highlight what areas in the current VAT system and legislation need consideration if the Minister of Finance's proposal is implemented.

### **1.6.6. Chapter 6**

#### **Summary, conclusion and recommendations**

This chapter will provide a summary of the findings from Chapters 2, 3, 4 and 5 with regard to whether the VAT structure in South Africa is sufficient for e-commerce and the proposal made by the Minister of Finance and possible problems experienced. A conclusion will be provided on how the current VAT structure in South Africa treats e-commerce transactions and what challenges and weaknesses should be considered if the VAT legislation is amended. Further considerations will be recommended relating to the new Tax Bill that is due to be implemented in 2014.

## **Chapter 2     Definition of electronic commerce transactions**

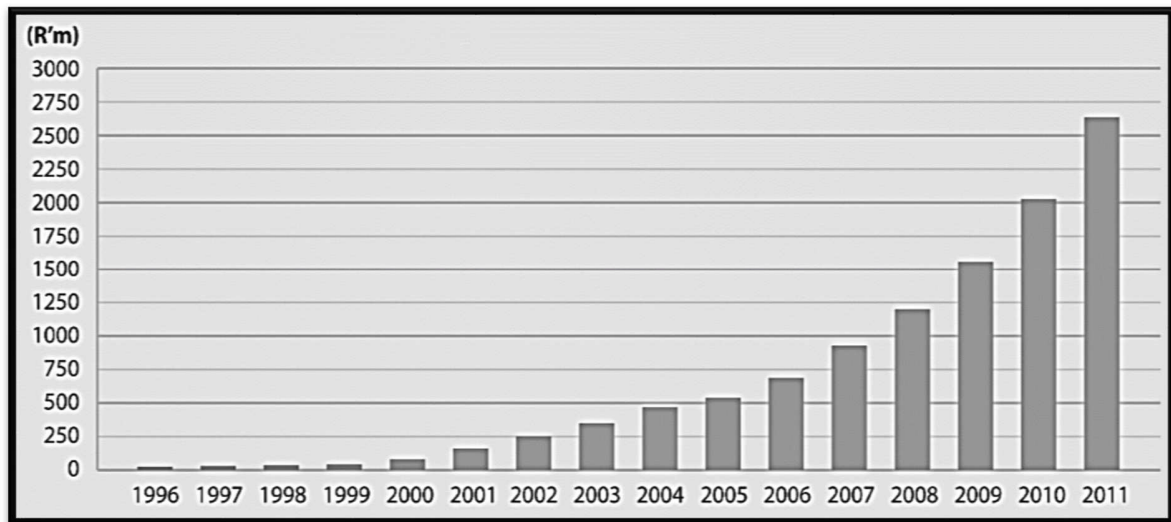
### **2.1.     Introduction**

The electronic transmission of images of certain products such as newspapers, magazines, reference material and photographs, and the downloading of computer software and recorded music, are becoming increasingly popular (Hargitai, 2001). The rapid growth in both the number of people who use the Internet and its commercial applications has been stimulated by technological innovations and their diffusion (OECD, 2000b). It was identified early that electronic commerce transactions had the potential to be one of the great economic developments of the 21<sup>st</sup> century. The information and communication technologies, which underlie this new way of doing business, opened up opportunities to improve global quality of life and economic wellbeing. Electronic commerce transactions had the potential to spur growth and employment in industrialised, emerging and developing countries (Committee of Fiscal Affairs, 1998).

This above statement was proved correct. At the end of 2010, 6.8 million South Africans were using the Internet; but by the end of 2011, that figure had increased to 8.5 million; and by the end of 2012, it was estimated to topple the 10-million mark (Meahl, 2012).

Figure 1 below indicates the growth that Internet sales in South Africa experienced from 1996 until 2011.

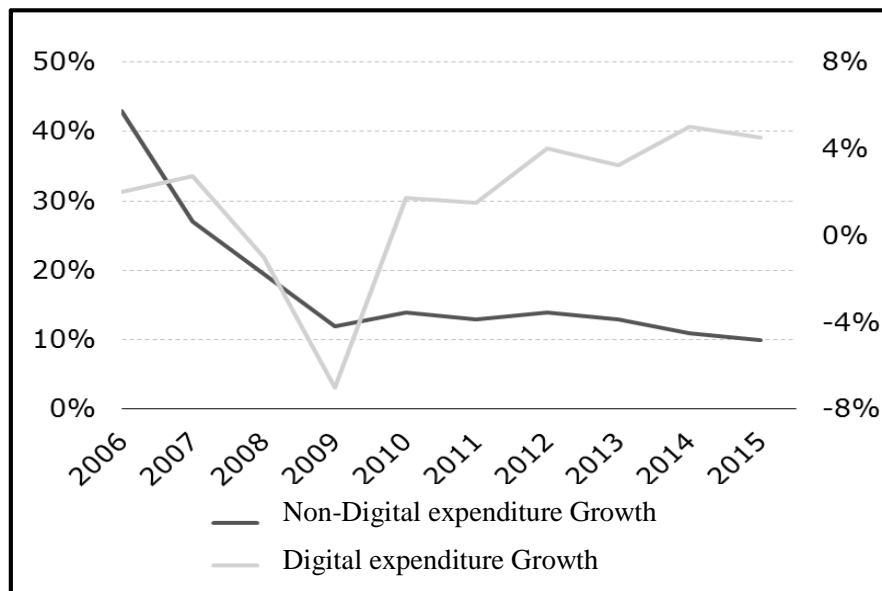
Figure 1: Internet sales in South Africa



Source: Goldstuck, 2012

The sales of digital goods increased during the last few years in the European Union following the same trend as experienced in South Africa. When comparing the spending growth in the European Union in Figure 2 against the spending growth of South Africa in Figure 1, it can be noticed that there is a parallel in the trend of the graphs (European Parliament, 2012). The sales growth rates for digital goods have exceeded the traditional dispatch of physical goods by a wide margin during the last number of years in the European Union, and this trend is expected to continue (European Parliament, 2012). When analysing the graph in Figure 2 below, it will be noted that, as the sales of the traditional dispatch of goods decreased, the sale of digital goods increased in the last years. The global digital and non-digital spending growth has shown a downward trend from 2006 until 2009. However, after 2009, global digital spending has started to grow again, whereas the non-digital spending had remained more or less constant (European Parliament, 2012).

Figure 2: E-commerce trends in the EU – Spending growth e-commerce: 2006-2015



Source: European Parliament, 2012

In order to address the objectives of the dissertation, firstly an understanding of e-commerce should be obtained. The definition of e-commerce should be investigated as well as the components it can be classified into in order to obtain a better understanding of e-commerce. Secondly, after an understanding of e-commerce has been obtained, the research will go further and analyse how other countries have implemented VAT on e-commerce transactions.

The term e-commerce has no widely accepted definition (OECD, 2000b). The definitions differ significantly depending on the various authors and sources. Some include all financial and commercial transactions that take place electronically, including electronic data interchange (EDI), electronic funds transfers (EFT) and all credit/debit card activities. According to others, electronic commerce transactions are limited to retail sales to consumers for which the transaction and payment take place on open networks such as the Internet (OECD, 1999). E-commerce transactions are also defined by Turban and King (2003) as the use of the Internet and the web to transact business. However, electronic commerce can also be defined in more detail as essentially the undertaking of normal commercial, government

and personal activities by means of computers and telecommunications networks and includes a wide variety of activities involving the exchange of information, data or value-based exchanges between two or more parties (Chan & Swatman, 1999). The differences in the above definitions are mainly attributed to the activities in the business environment, applications of e-commerce transactions and communication networks used to construct the definition. Therefore, the definition will differ from one company to another depending on how and where e-commerce transactions are used.

There are a number of existing models that attempt to provide a framework that can be used by parties of a transaction to define or understand the breadth and scope of e-commerce transactions (Chan & Swatman, 1999). Therefore, to obtain a better understanding of e-commerce and the definition thereof, one has to investigate the different models that have been developed to date to define e-commerce.

## **2.2. Different models defining e-commerce**

Electronic commerce has so many different components that there is clearly a need to categorise it systematically. Models and frameworks offer greater clarity in the study of many areas of research (Chan & Swatman, 1999). A few of the models will be discussed to obtain a better understanding of the characteristics of e-commerce, which will be useful when investigating the definitions of e-commerce.

### **2.2.1. Zwass's Hierarchical Framework**

The Zwass model presents a systematic view of the organisation of the complex enterprise of e-commerce within a hierarchical framework, extending from the networking infrastructure to global marketplaces (Zwass, 1996). Electronic commerce transactions include sharing business information, maintaining business relationships, and conducting business transactions by means of telecommunications networks (Zwass, 1998).



The established way to analyse and develop very complex systems, such as e-commerce, is to structure it in a hierarchy of several levels. Each of the lower levels should deliver a well-defined functional support to the higher levels (Zwass, 1998). Such a hierarchical framework of e-commerce is shown in Table 1.

Zwass presented a very comprehensive hierarchical framework of e-commerce, consisting of three meta-levels, namely infrastructure, services and products structures, as well as seven functional levels, which range from wide-area telecommunications infrastructure to electronic marketplaces and electronic hierarchies (Chan & Swatman, 1998).

The framework recognises that e-commerce consists of three meta-levels. Each of the lower levels, starting at 1, is delivering a well-defined functional support to the higher level (Zwass, 1998).

The below table could be explained as follows:

The first three levels of the hierarchical framework form the technological infrastructure of e-commerce transactions. This foundation is the intermeshed network of wide-area telecommunication networks, extended by the metropolitan and local-area networks. The infrastructure consists of the hardware, software, databases and telecommunications that are deployed to deliver such functionality as the World Wide Web via the Internet, including support to EDI and other forms of messaging via the Internet or via value-added networks (Zwass, 1998).

The meta-level of services consists of provision of secure messaging and of enabling services for e-commerce transactions. Taken together, these services provide the business infrastructure for e-commerce transactions. This second meta-level is services that consist of messaging and a variety of services enabling the finding and delivery of information, including a search for potential business partners, as well as the negotiation and settlement of a business transaction (Zwass, 1998).

Products and structures of e-commerce transactions cover three-categories: consumer-oriented commerce, business-to-business commerce, and intra-organisational business. All three are experiencing vigorous developments, albeit with differing economic outcomes at this time. This third meta-level is the products and structures that are broken down in direct provision of commercial information-based goods and services to consumers and business partners, intra- and inter-organisational information sharing and collaboration and the organisation of electronic marketplaces and supply chains (Zwass, 1998).

Table 1: The hierarchical framework of e-commerce

Meta-Level	Level	Function	Examples
<b>Products and structures</b>	7	Electronic marketplaces and electronic hierarchies	<ul style="list-style-type: none"> <li>• Electronic auctions, brokerages, dealerships and direct search markets.</li> <li>• Inter-organisational supply-chain management</li> </ul>
	6	Products and systems	<ul style="list-style-type: none"> <li>• Remote consumer services (retailing, banking, stock brokerage)</li> <li>• Infotainment-on-demand (fee-based content sites, educational offerings)</li> <li>• Supplier-customer linkages</li> <li>• On-line marketing</li> <li>• Electronic benefit systems</li> <li>• Intranet- and extranet-based collaboration</li> </ul>
<b>Services</b>	5	Enabling services	<ul style="list-style-type: none"> <li>• Electronic catalogues/directories, smart agents</li> <li>• E-money, smart-card systems</li> <li>• Digital authentication services</li> <li>• Digital libraries, copyright-protection services</li> <li>• Traffic auditing</li> </ul>
	4	Secure messaging	<ul style="list-style-type: none"> <li>• EDI, e-mail, EFT</li> </ul>
<b>Infrastructure</b>	3	Hypermedia/multi-media object management	<ul style="list-style-type: none"> <li>• World Wide Web with Java</li> </ul>
	2	Public and private communication utilities	<ul style="list-style-type: none"> <li>• Internet and value-added networks (VANs)</li> </ul>
	1	Wide-area telecommunications infrastructure	<ul style="list-style-type: none"> <li>• Guided- and wireless-media networks</li> </ul>

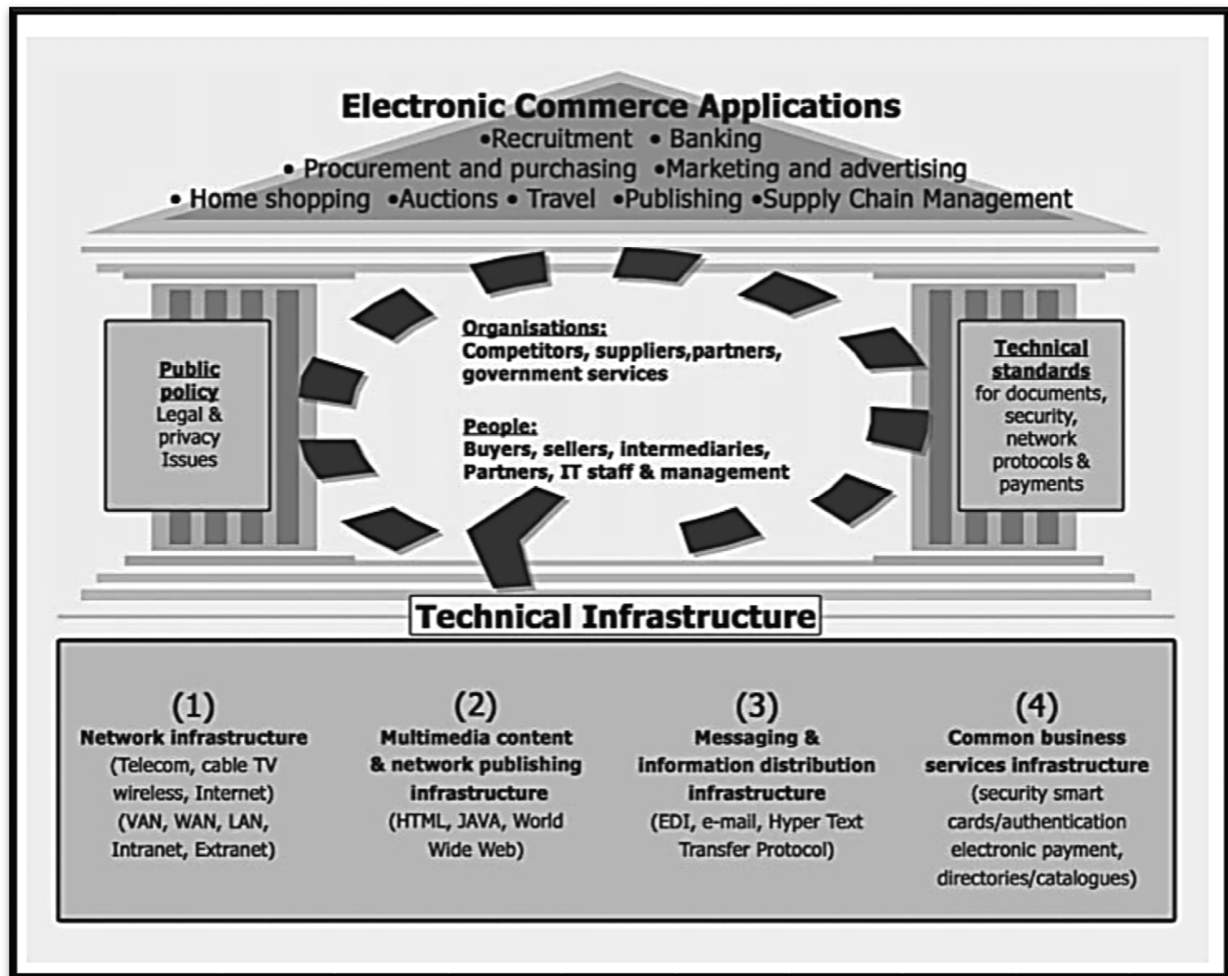
Source: Zwass, 1998

### **2.2.2. Kalakota and Winston's "Pillars" Framework**

Using a very different scheme from that by Zwass, the use of a metaphor of "pillars" (public policy and technical standards), to support four infrastructures (network, multimedia content, messaging, and common business services) on top of which they place e-commerce applications (Chan & Swatman, 1999). This is a holistic view of e-commerce and identifies the different components of business and technology that constitute e-commerce. All the elements interact to produce the most visible manifestation of e-commerce (Turban & King, 2003).

Figure 3 below illustrates how different components fit and interact together, emphasising the relative importance of each component (Turban & King, 2003). This model is simple to understand and visually attractive; however, it lacks theoretical depth and is not particularly useful for researchers endeavouring to incorporate it into empirical research projects (Chan & Swatman, 1999).

Figure 3: Pillars Framework



Source: Turban & King, 2003

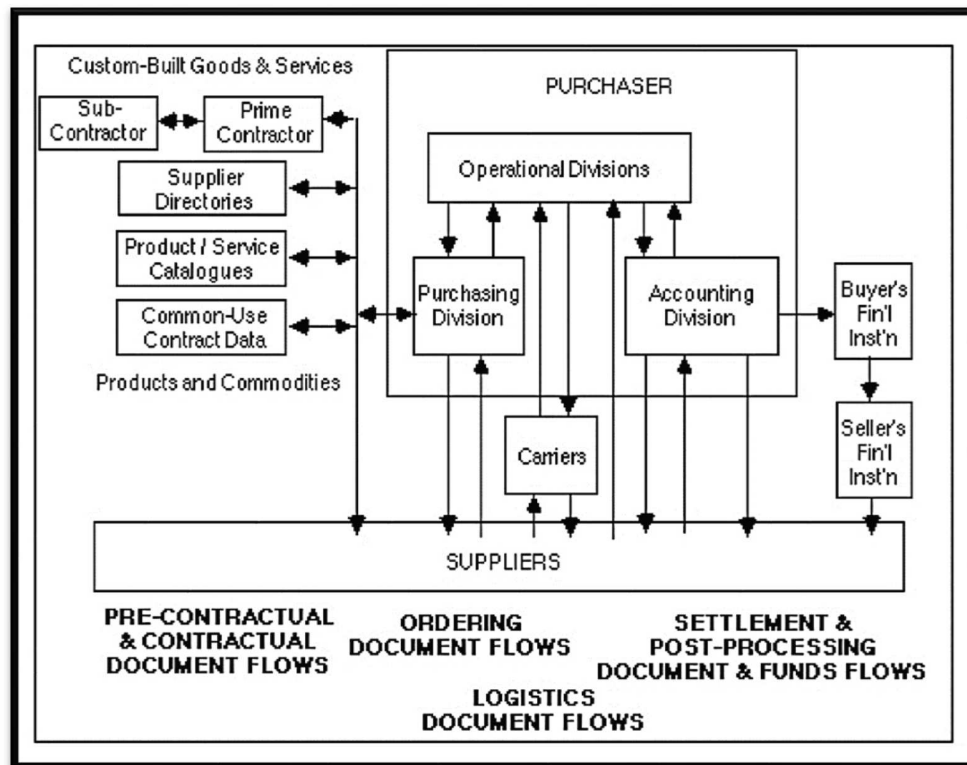
### 2.2.3. Clarke's Five-Phase Process Model

There are various ways in which sellers and buyers discover one another, and several ways in which the negotiation of price, quantity, delivery and related terms and conditions are performed. This model describes a five-phase process of electronic commerce designed to support the different phases of a business transaction (Clarke, 2013).

The five phases consist of the following:

- **The pre-contractual phase**, concerned with the gathering of 'intelligence' concerning the products or services being sought, and the discovery of the sources of supply;
- **The contractual phase**, in which a formal relationship between buyer and seller is created, including the establishment of the terms and conditions to apply to transactions under the contract;
- **The ordering and logistics phase**, in which purchase orders are placed and processed, the goods transported and/or the services provided, and post-delivery functions (e.g. inspection and acceptance/rejection) performed;
- **The settlement phase**, in which invoicing, payment authorisation, payment and remittance advice transmission take place;
- **The post-processing phase**, in which management information is gathered and reported, and the storage and analysis of trade statistics take place (Clarke, 2013).

Figure 4: Five-phase Process Model



Source: Clarke, 2013

#### 2.2.4. Wigand's typology

It has been identified that modern communication and information technologies can enable change in organisation structure and business processes, and they influence the competitive advantage of firms. In broad terms, electronic commerce transactions include any form of economic activity conducted via electronic connections. The bandwidth of 'electronic commerce' spans from electronic markets to electronic hierarchies and incorporates electronically supported entrepreneurial networks and cooperative arrangements (Wigand, 1997).

Electronic commerce denotes the seamless application of information and communication technology from its point of origin to its endpoint along the entire value chain of business processes conducted electronically and is designed to enable the accomplishment of a business goal. Following this definition, Table 2 identifies some criteria leading to a typology of electronic commerce (Wigand, 1997).

A number of criteria are identified that can be used to define a typology of electronic commerce. The components of this typology range from one-way teleshopping broadcasts via cable and satellite television channels, to electronic shopping on the Internet and World Wide Web (Chan & Swatman, 1999).

This typology has mainly been designed to categorise the types of electronic business based on their electronic interactive capabilities and does not reflect the full range of electronic commerce activities (Chan & Swatman, 1999).



Tabel 2 - An Electronic Commerce Typology

Type of Electronic Commerce, by increasing electronic interactive capabilities	Buyers' deliberate choice/ decision at time of transaction	Automatized buying transactions	Degree of interactivity	Buying choice/decision made by computer/software on behalf of buyer	Direct buying choice/ decision made by human	Potential for full-fledged electronic market	Role of market maker
Teleshopping via television (e.g. QVC)	Yes	One-way only	Limited, one-way	No	Yes	High and successful but only partially electronic	High
Automated market(A): Simple, largely automated transactions (e.g. EFT, EDI, SWIFT, valued added services)	Yes and No	Largely yes	High	Largely yes	No	Limited, only transaction and processing system	Small
Automated Market (B): Simple transactions with some human choices/decisions required (e.g. SABRE, APOLLO, stock market transactions)	Yes	One-way only	High	Generally no	Yes	High and successful	Medium
Mobile and wireless cellular phone/PCS-based applications (e.g. construction industry)	Yes	No	High	No	Yes	High	Small
Electronic shopping (e.g. via Internet, WWW)	Yes	No	High	No	Yes	High	High
Full-fledged electronic commerce utilizing electronic market maker with market-choice box (e.g. available in the future via 500 cable television systems, phone, maybe wireless, etc.)	Yes	Mainly one-way only	High	No	Yes	High	Very High

Source: Wigand, 1997

From Table 2, it can be seen that e-commerce transactions will not be very practical without the use of an effectively working intelligent agent assisting the consumer in searches, comparisons and evaluations. It appears that in all conditions the buyer's deliberate choice or decision at the time of the transaction is assumed or required. Interactivity tends also to be high in most electronic commerce transaction settings. It also appears that the higher the degree of interactivity, the more perfect the electronic market might be (Wigand, 1997).

Table 2 also suggests that the role of the market maker varies considerably with the various forms and types of e-commerce. The market maker's most prominent role is evident when the market maker is the driver of the electronic market and can offer single-source channels, as in the case of teleshopping, electronic shopping or the full-fledged e-commerce situation using a market choice or set-top box (Wigand, 1997).

#### **2.2.5. Summary of the different models of e-commerce**

It is clear that while all these models are useful in specific circumstances, none is capable of providing an inclusive definition of e-commerce types, activities and capabilities (Chan & Swatman, 1999). However, a few key characteristics can be identified that are similar in the above models.

According to Zwass (1998), there are three meta-levels to e-commerce, namely products, services and infrastructure. These meta-levels could be obtained in five phases, according to Clarke, namely the pre-contractual phase, the contractual phase, the ordering and logistics phase, the settlement phase and the post-processing phase.

When comparing Zwass' Hierarchical framework with the typology of Wigand and also the Kalakota and Whinston Pillars model, it will be noticed that there is a similarity in the type of e-commerce identified for the structuring of each model such as wireless internet, electronic funds transfer (EFT), wireless media networks etc. This is important to note in order to draw a conclusion of what will be considered the most similar ways of

performing e-commerce transactions in the business and home environment. Therefore, the conclusion can be drawn that these models take the same technical infrastructure and transactions into account when forming the individual models. Furthermore, it will be noticed that different elements of business and technology are also taken into consideration in the Kalakota and Whinston Pillars Model where some of the other models have not. The Pillars Model has taken into consideration that there is a public policy, which will have legal and privacy issues relating to the e-commerce.

As an understanding was obtained of the different elements of the models that could be used to define e-commerce, different definitions published and definitions used today will be scrutinised to obtain an understanding of how e-commerce is defined in the business environment.

Electronic commerce has become a priority area for many international organisations and revenue authorities have an important role to play in realising the full potential of e-commerce (OECD, s.a.). Therefore, it is important to obtain an understanding of the different definitions used by different countries and organisations to ensure that a complete overview is obtained of e-commerce transactions and that it is correctly addressed by the additional implementations in the current legislation.

### **2.3. Definitions by the OECD, other countries and authors**

As indicated in Chapter 1, the VAT system in the European Union is similar to the VAT system in South Africa. Because the European Union has based its changes to the VAT system on the recommendations made by the OECD, the definitions supplied by the EU and OECD will be considered and compared to the South African version. The OECD is involved in the forming of a framework for the taxation of e-commerce, therefore the definition the OECD has formed will be analysed. Another VAT system that was identified to be similar to the South African and European VAT systems is the system implemented in New Zealand.

The New Zealand GST system is considered superior to the EU VAT system in tax literature (Copenhagen Economics, 2013). Therefore, consideration will also be given to how New Zealand is defining e-commerce for VAT purposes.

### **2.3.1. Organisation for Economic Co-operation and Development**

The roots of the organisation go back to the rubble of Europe after the Second World War (Anon, 2011). The Organisation for European Economic Co-operation (OEEC) was established in 1948 by 18 European countries to run the US-financed Marshall Plan for reconstruction of a continent ravaged by World War II (OECD, s.a.). George C Marshall, with regard to the US Financed Marshall Plan, stated: “It is logical that the United States should do whatever it is able to do to assist in the return of normal economic health in the world, without which there can be no political stability and no assured peace. Our policy is directed not against any country or doctrine but against hunger, poverty, desperation, and chaos” (Marshall, 1947). Determined to avoid the mistakes of their predecessors in the wake of the First World War, European leaders realised that the best way to ensure lasting peace was to encourage co-operation and reconstruction, rather than to punish the defeated (Anon, 2011). By making individual governments recognise the interdependence of their economies, it paved the way for a new era of co-operation that was to change the face of Europe (OECD, s.a.).

Encouraged by its success and the prospect of carrying its work forward on a global stage, Canada and the US joined OEEC members in signing the new Organisation for Economic Co-operation and Development (OECD) Convention on 14 December 1960. The OECD was officially born on 30 September 1961, when the Convention entered into force to create an organisation dedicated to global development (OECD, s.a.).

The OECD uses its wealth of information on a broad range of topics to help governments to foster prosperity and fight poverty through economic growth and financial stability. It also ensured that the environmental implications of economic and social development are taken into account. The work is based on the continued monitoring of events in member countries as well as outside the OECD area, and includes regular projections of short- and medium-term economic developments (OECD, s.a.).

It was identified that electronic commerce transactions cause tax problems primarily when they cross boundaries between taxing jurisdictions, for example between members of the EU or between members and other nations (McLure, 2003). While the evolution of electronic commerce transactions raise issues in the application of traditional consumption tax rules, these issues are compounded by the potential for different implementing legislation in individual countries (OECD, 2003c). Differences in the treatment of cross-border supply of services and intangibles across countries have become more tangible, with a resulting need to address them in order to prevent double taxation and unintended double non-taxation (Charlet & Buydens, 2012).

Therefore, the OECD and the Government of Canada jointly organised a Ministerial Conference on Electronic Commerce in Ottawa from 7 to 9 October 1998. For the first time at an OECD Ministerial event, leaders from national governments (29 member countries and 11 non-member countries), the heads of major international organisations, industry leaders, and representatives of consumer, labour and social interests came together to clarify respective roles, discuss priorities and develop plans to promote the development of global electronic commerce transactions. The issue at the Ottawa conference was how to implement tax policies and procedures without distorting the new and traditional economies. Several approaches were discussed by the OECD's Committee on Fiscal Affairs (CFA) (Charlet & Buydens, 2012). Ministers also welcomed the report: *Electronic Commerce: Taxation Framework Conditions*, and endorsed the proposals on how to take forward the work contained in it (OECD, s.a.).

The OECD has suggested that because of inherent differences in policy interests and feasibility of definitions, a framework to define various aspects of electronic commerce transactions for different purposes may be the most practical (OECD, 2002).

The OECD has defined an electronic transaction in April 2000 in their Annexure 4 as follow: “An electronic transaction is the sale or purchase of goods or services, whether between businesses, households, individuals, governments, and other public or private organisations, conducted over computer-mediated networks. The goods and services are ordered over those networks, but the payment and the ultimate delivery of the good or service may be conducted on or off-line” (OECD, 2002).

Electronic commerce transactions can therefore be defined as the application of information and communication technology to any of the activities involved in making commercial transactions (OECD, 2003b).

### **2.3.2. European Union**

The definition of e-commerce established by the European Union is important to consider as the European Union was the first to implement VAT on e-commerce and had many developments in this area.

Numerous problems occurred in the European Union when the previous system of VAT was applied to Internet transactions. In order to adapt the taxation mechanisms to the needs of e-commerce, several measures have been taken. One of the measures taken was defining e-commerce for VAT purposes. The definition implemented by the EU is investigated because the European Union rule on the taxation of Internet transactions that was passed was in line with the principles of e-commerce taxation developed by the OECD (Pronina, 2011).

In the Directive published by the European Commission when transforming their VAT system, the following was included in the definition of e-commerce:

“Examples of services covered by the Directive include online information services (such as online newspapers), online selling of products and services (books, financial services and travel services), online advertising, professional services (lawyers, doctors, estate agents), entertainment services and basic intermediary services (access to the Internet and transmission and hosting of information)” (European Commission, 2013).

### **2.3.3. New Zealand**

In the literature, the EU VAT system is often compared with the ‘modern’ GST systems in Australia and New Zealand (Copenhagen Economics, 2013). Because the New Zealand GST system is considered more modern and superior than the European VAT system (Copenhagen Economics, 2013), the definition provided for e-commerce is important to consider in the current research to achieve a well-rounded conclusion on this matter.

New Zealand, like any other country, has needed to define what is meant by e-commerce transactions and to then decide how it affects the law and how the law affects it (Osborne, 1999).

In a paper published by the New Zealand Parliament, the following definition was noted: “E-commerce” refers to the buying and selling of goods and services via electronic networks, principally the Internet. Its definition is sometimes expanded to include other aspects of e-business (New Zealand Parliament, 2001).

E-commerce transactions are a generic name for business transactions that are entered into through electronic rather than paper-based means. It is not limited to the commercial use of the internet, although that is an important example of e-commerce transactions (New Zealand Law Commission, 1998).

#### **2.3.4. Comparison of the definitions in the OECD, European Union and New Zealand**

E-commerce transactions essentially mean the undertaking of normal commercial, government and personal activities by means of computers and telecommunications networks and include a wide variety of activities involving the exchange of information, data or value-based exchanges between two or more parties (Chan & Swatman, 1999).

Based on the above definitions, it appears that none of these definitions are the same, but there are similarities. These definitions make it clear that e-commerce involves the use of computer and telecommunications technologies to improve business processes (Chan & Swatman, 1999). It can be noted that the fundamental characteristic of e-commerce is similar (Chetcuti, 2002). The conclusion that can be drawn from the comparison of the definition is that what distinguishes e-commerce from traditional commercial activity is that it is conducted by electronic means (Chetcuti, 2002)

### **2.4. E-commerce transactions in South Africa**

#### **2.4.1. Definition of e-commerce transactions**

In the Green Paper on Electronic Commerce for South Africa, the following definition was stated:

The use of electronic networks to exchange information, products, services and payments for commercial and communication purposes between individuals (consumers) and businesses, between businesses themselves, between individuals themselves, within government or between the public and government and, last, between business and government (Department of Communications, 2000).



This definition encompasses the many kinds of business activities that are being conducted electronically, and conveys the notion that electronic commerce transactions are much more comprehensive than simply the purchasing of goods and services electronically (Department of Communications, 2000).

After the proposal made in the 2013/2014 budget speech by the Minister of Finance, a Draft Taxation Law Amendment Bill 2013 was published for public comments. In this draft Bill, the following definition for e-commerce was stated: “‘E-commerce services’ means the supply of any services where the placing of an order and delivery of those services is made electronically” (Minister of Finance, 2013).

With the new definition of e-commerce it is presently unclear whether the definition is intended to apply only to goods ordered and delivered online – such as music, books and clothes – or whether the legislator has a wider application in mind to include, for example, the provision of virtual professional services (Lessing, Mazansky, Rood, McGurk & Malan, 2013).

#### **2.4.2. Comparison of the South African definition with other countries’ definitions**

When comparing the new electronic commerce definition of South Africa with the definitions of other countries, it can be seen that they all have a similarity when placing an order. The ordering and delivering of the goods or services are made electronically.

However, it will also be noticed that all these definitions include different types of services and goods, and it is left open for interpretation whether goods or services will fall into the definition of e-commerce for specific countries.

It can, however, be argued, although the definitions do not clearly define what goods or services are to be included in e-commerce, that the characteristics will be the same for these transactions. According to Chetcuti (2002), e-commerce can be characterised by the following features:

- Potentially virtual: The presence of an enterprise in another country may be wholly based on the hosting of a website on a server located there;
- Disinter-mediated and less labour intensive: The main enterprise no longer requires intermediaries in foreign countries to be able to conduct business there. Moreover, e-business activities require far less human intervention, if any, than that otherwise required to trade by in a traditional manner;
- Global: The scope of market-penetration is unlimited and knows no borders;
- Anonymous: Business is transacted on a non-face-to-face basis and therefore the seller and the consumer may not be known to each other.

As can be seen from the above, there is no fixed indication of what type of goods and services will be regarded as e-commerce. Different types of e-commerce have already been identified in the models discussed; however, they differed from model to model. It was identified that e-commerce can be further broken down into two categories, i.e. *direct* and *indirect* e-commerce. These two categories will be investigated to broaden the understanding of what e-commerce is, how transactions will be classified and which transactions will be applicable for this research.

## **2.5. Direct and indirect e-commerce**

It was identified that e-commerce transactions can be divided into two categories, namely direct e-commerce and indirect e-commerce. To achieve the objectives of this research, it is necessary to indicate which type of e-commerce transactions will be relevant to this research.

### **2.5.1. Direct e-commerce**

Direct electronic commerce transactions, on the other hand, utilise the virtual marketplace fully, not only by means of transferring information, but also during all phases in the commercial activity, which happens online, including delivery (Hargitai, 2001).

The fact that an e-commerce function exists almost exclusively on the Internet platform makes e-commerce different from conventional commercial activities (Siliafis, 2007). Unlike the export and import of physical goods, no border post or post office can perform the function as collecting agent (Ernst & Young, 2013). Electronic commerce transactions present opportunities to expand or shift elements of existing, traditional channels from the physical marketplace to the virtual marketplace (Rayport & Sviokla, 1994). The absence of any real control point, along with the disintermediation process discussed previously, makes it more difficult for tax authorities to scrutinise or verify economic activity and resulting taxable profits or sales (Cockfield, 2002).

The extensive opportunities for tax avoidance and the *de facto* exemption from tax of numerous transactions on the Internet create great interest among fiscal authorities and ministries of finance (Bleuel & Stewen, 2000).

When looking at direct electronic commerce transactions, the intangible nature of many e-commerce transactions, such as a supply of a digitised product, means that in order to deliver the product it is not essential for the supplier to have the customer's physical address (OECD, 2003a). Digital goods and services do not require a tangible medium to

be delivered and can be easily transmitted from a distance through the Internet (Korpusov, 2011). Therefore, unlike the export and import of physical goods, no border post or post office can perform the function as a collecting agent for VAT on the services (Sathasivan, 2013).

Where a supply is now made in electronic form (an electronic supply), this refers to the delivery of intangibles through the medium of a digital channel. Therefore, this delivery is not made via post service or commercial courier, but via the Internet (Alexiou & Morrison, 2004) and it raises the problem that the delivery did not go through customs. This raises the tax issue of possible sales tax erosion.

#### **2.5.2. Indirect e-commerce**

Indirect e-commerce means the electronic ordering of tangible goods. The definition indicates that transactions belonging to this group make use of the Internet for the purposes of providing information, ordering products and perhaps payment. This phase of delivery happens through traditional channels such as border posts and customs (Hargitai, 2001).

Indirect e-commerce's process is when physical goods are produced at a manufacturing plant, shipped off to wholesalers, and boxed on to retailers – the final consumer walking away with a paid for (and taxed) product. Tax collection was in the hands of the retailers who would charge the consumer VAT or sales tax and then remits this to the taxing authorities (Jones & Basu, 2002).

#### **2.5.3. Summary of direct and indirect e-commerce**

Therefore, the focus for this research will be on direct e-commerce, where all transactions conducted and delivered are electronically or online.

Global e-commerce makes the cross-border movements in goods, capital and labour less transparent, allowing companies and individuals to exploit tax differences between countries, or even to evade taxation completely (Jones & Basu, 2002).

Consequently, there is legitimate concern from Governments, especially in developing countries, regarding the potential erosion of their tax base resulting from e-commerce if domestic and international rules are not modified to take account of these developments (Teltscher, 2000).

Based on the above discussion, it was established that e-commerce is divided into two types of e-commerce, namely direct and indirect e-commerce. The main difference identified is that direct e-commerce is intangible, while indirect e-commerce is tangible.

To be able to address the objectives of this research, it has to be established whether direct e-commerce, as identified, will be classified as goods or services for VAT purposes, because there are different rules applicable to goods and services under the VAT Act.

## **2.6. Goods and services**

To be able to understand the VAT implications on e-commerce, it has to be established whether e-commerce will be considered goods or services in terms of the South African VAT Act. The South African VAT Act has different rules with regard to the importation of services and the importation of goods.

The classification of digitised products for VAT purposes either as goods or as services has a fundamental effect on the rules that apply to the imposition of VAT on the supply of such services (De Swart & Oberholzer, 2006).

### 2.6.1. Goods and services in the European Union

According to the sixth VAT directive, the goods and services can be defined as follow:

‘Supply of **goods**’ shall mean the transfer of the right to dispose of tangible property as owner. In addition, each of the following shall be regarded as a supply of goods:

- (a) The transfer, by order made by, in the name of a public authority, or in pursuance of the law, of the ownership of property against payment of compensation;
- (b) the actual handing over of goods pursuant to a contract for the hire of goods for a certain period, or for the sale of goods on deferred terms, which provides that in the normal course of events ownership is to be passed at the latest upon payment of the final instalment;
- (c) the transfer of goods pursuant to a contract under which commission is payable on purchase or sale (Council Directive 2006/112/EC, 2006).

‘Supply of **services**’ shall mean any transaction which does not constitute a supply of goods. A supply of services may consist, inter alia, in one of the following transactions:

- (a) The assignment of intangible property, whether or not the subject of a document establishing title;
- (b) The obligation to refrain from an act, or to tolerate an act or situation;
- (c) The performance of services in pursuance of an order made by, in the name of a public authority, or in pursuance of the law (Council Directive 2006/112/EC, 2006).

When looking at the European Union VAT system, the categorisation of the EU-VAT rules of the Sixth Directive into goods or services seems clear, as electronic transactions are delivered digitally, which is classified to be intangible and therefore not in physical form. This corresponds to an EU proposal that for VAT purposes trade in digital goods be treated as a supply of services (Jones & Basu, 2002). It follows that intangible property does not constitute goods, therefore falls within the definition of services (Hargitai, 2001).

### **2.6.2. Goods and services in South Africa**

When referring to the VAT Act of South Africa for the definition of goods and services, the following was found:

“Goods” are, *inter alia*, defined in section 1 as meaning “corporeal movable things, fixed property and any real right in any such thing or fixed property” (VAT Act, 1991).

From the definition of goods, it seems clear that intangible things such as intellectual property or personal rights will not be regarded as goods for VAT purposes (Classen, 2004).

“Services” are, *inter alia*, defined in section 1 as “anything done or to be done, including the granting, assignment, cession or surrender of any right and the making available of any facility or advantage” (VAT Act, 1991).

This definition of services is very wide and includes almost any perceivable transaction (Classen, 2004). In South Africa, there is no legislative definition of electronically supplied services for VAT purposes. The VAT Act does not contain a specific provision that determines how digitised goods will be taxed (De Swart & Oberholzer, 2006). E-commerce supplies are therefore deemed services, because they are not considered tangible items (Alexiou & Morrison, 2004). It is clear that intangible goods are defined as services for the purpose of the VAT Act, but that is as far as it goes (Smuts, 2012).

The Green Paper on Electronic Commerce (Department of Communications Republic of South Africa, 2000) for South Africa confirms this view and is in accordance with the OECD's point of view that electronic products should not be classified as goods (Classen, 2004).

### **2.6.3. Summary of e-commerce defined as services or goods**

Based on the above definitions and discussions, it could be concluded that e-commerce would be defined as services. This would be in line with the policy implemented in the European Union. In addition, the OECD also proposed to treat digitised products as services when the original framework for taxation on e-commerce was developed (Jones & Basu, 2002).

Therefore, for this research, all direct e-commerce would be regarded as services.



## **2.7. Conclusion**

Based on the information discussed in this chapter, certain characteristics of e-commerce were highlighted, as well as how they should be classified.

E-commerce will be all transactions conducted via the Internet, in whichever form. E-commerce can be divided into two types of e-commerce transactions, namely direct e-commerce and indirect e-commerce. The focus of this study will be on direct e-commerce, where all transactions conducted, and delivered are electronically or online. The goods that are delivered will be considered intangible goods. As per the definitions by the European Union and South Africa, intangible goods will be considered a service. Therefore, it will be taxed as a services being imported as per the VAT Act in South Africa.

As there is now a clear understanding as to what constitutes e-commerce and what the focus of this research will be, the following chapter will address how different countries are treating VAT on e-commerce.

## **Chapter 3     VAT in the European Union and elsewhere**

### **3.1.     Introduction**

In Chapter 2, the definition of e-commerce and the different components of e-commerce were discussed. In Chapter 3, the different countries that have implemented VAT on e-commerce in their VAT systems will be analysed to obtain an understanding of the VAT systems and how they were effected. This will be compared to South Africa's current VAT system in Chapter 5.

The OECD was originally established to promote policies and assist with the design to achieve the highest sustainable economic growth and employment and rising standard of living in member countries, while maintaining financial stability, and thereby contributing to the development of the world economy (OECD, 2001). The OECD was first to establish a framework for the taxation of e-commerce. This was because the OECD realised that electronic commerce has an enormous potential to change the way people work, play and organise their lives. If this potential is to be fully realised, the OECD decided they must provide a taxation framework that provides certainty, fairness, and neutrality and that avoids the establishment of new tax obstacles for this new form of doing business (OECD, 2001). Therefore, the principles that were identified by the OECD for taxation on e-commerce will first be reviewed before a further investigation will be conducted on how VAT on e-commerce was implemented in different countries.

### **3.2.     Organisation for Economic Co-operation and Development**

With the 'taxation framework' adopted at the conference in Ottawa as per paragraph 2.3.1 of Chapter 2, the members of the OECD came to an understanding that they will treat e-commerce in a neutral way with regard to taxation. In other words, they will neither discriminate against e-commerce by placing additional taxes ('bit taxes') on it, nor will they favour it compared to conventional transactions by installing tax-free zones (Bleuel & Stewen, 2000). The principles that were agreed on include neutrality, efficiency, certainty

and simplicity, effectiveness and fairness and flexibility, which are discussed in more detail below (OECD, 2003c).

### **3.2.1. Neutrality**

It was agreed that taxation should seek to be neutral and equitable between forms of e-commerce transactions. In other words, this will mean that taxation should be neutral and equitable between conventional and electronic forms of commerce. Taxpayers in similar situations carrying out similar transactions should be subject to similar levels of taxation (OECD, 2003c). Therefore, e-commerce transactions should be subject to taxation if their 'physical equivalents' are subject to taxation (Pinkernell, s.a.).

### **3.2.2. Efficiency**

Secondly, compliance costs for taxpayers and administrative costs for the tax authorities should be minimised as far as possible (OECD, 2003c). When considering taxation, efficiency might be far more crucial than neutrality. From a state perspective, an inefficient taxation system does not fulfil its purpose of bringing in the revenue to the state if it is compared to costs related to its inefficiency, such as market distortions and compliance costs (Rendahl, 2009).

### **3.2.3. Certainty and simplicity**

Thirdly, it was decided that the tax rules should be clear and simple to understand in order to promote certainty and simplicity so that taxpayers can anticipate the tax consequences in advance, including knowing when, where and how the tax is to be accounted for (OECD, 2003c). Having certainty and simplicity as goals for drafting legislation is essential for the fulfilment of several other principles in the framework principles. To decrease compliance and administrative costs and reach legally efficient legislation, taxpayers must be able to foresee the consequences of their business decisions (Rendahl, 2009).

#### **3.2.4. Effectiveness and fairness**

Effectiveness and fairness were the fourth principle that was agreed upon at the Ottawa Conference. Effectiveness may perhaps have a stronger focus on compliance costs than efficiency relating to (Rendahl, 2009) producing the right amount of tax at the right time (OECD, 2003c). Reaching effectiveness in the sense of producing the right amount of tax at the right time would, however, also create fairness. Fairness may also indicate similarities in horizontal equity, where individuals under similar circumstances are taxed equally or similar transactions are taxed equally (Rendahl, 2009). The potential for tax evasion and avoidance should be minimised, while keeping counter-acting measures proportionate to the risks involved (OECD, 2003c).

#### **3.2.5. Flexibility**

Lastly, it was stated that the systems for taxation should be flexible and dynamic to ensure that they keep pace with technological and commercial developments (OECD, 2003c).

At the time of the 1998 OECD Ministerial meeting on electronic commerce transactions, it was also proposed that the OECD should form Technical Advisory Groups (TAGs) to assist in taking forward the work on taxation and electronic commerce transactions. The role would be purely advisory, but its members' knowledge and experience assist the Committees in taking their work forward (Hellerstein, 2008). As a result, a number of small Technical Advisory Groups were formed consisting of business and government representatives to develop responses and solutions to the key issues identified at the conference (Jenkins, 1999). The few issues identified that will be investigated by the TAGs were the application of the definition of royalties within the context of e-commerce transactions, how the current tax treaty rules for the taxation of business profits apply regarding e-commerce transactions, and advising on the practical implementation of the Ottawa principle of taxation in the place of consumption (OECD, 2001). Five groups were established in January 1999 for two years to allow them time for

a thorough consideration of all the issues (Jones & Basu, 2002). The representatives from tax authorities and business are supported by academics and drawing on input from non-OECD economies (Committee of Fiscal Affairs, 2010).

The five TAGs created were the Treaty Characterisation TAG, the Business Profits TAG, the Consumption Tax TAG, the Technology TAG and the Professional Data Assessment TAG (OECD, 2001).

One of the groups, The Consumption Tax TAG, examined consumption taxes and electronic commerce transactions in three areas, namely the rules for consumption taxation of cross-border trade, whether the supply of digitised products must be treated as a supply of services, and mechanisms that can be used to provide immediate protection to the revenue base (Jones & Basu, 2002). Another group, the Business Profit TAG's general mandate was to "examine how the current treaty rules for the taxation of business profits apply in the context of electronic commerce transactions and examine proposals for alternative rules" (OECD, 2002). Various ideas have been put forward at different stages, and have been considered by the technical advisory groups reporting to the OECD (Jenkins, 1999). All of the TAGs provided valuable input. The non-member and business input into the policy development process proved very important in helping to identify more soundly-based and widely acceptable policy positions. Business and government members of the Technology TAG and Consumption Tax TAG fully recognised the need to identify a practical short-term solution to meet the needs of governments, without negatively influencing the ability of businesses to engage in on-line commerce or imposing unreasonable compliance burdens (OECD, 2001). All the groups had specific issues to address and reports were issued based on the conclusions made. These TAGs were discontinued in 2001 after their work was completed (Hellerstein, 2008).

This framework and principles were compiled by the OECD to be used as guidelines by countries to adjust their VAT systems for e-commerce. The European Union was the first tax jurisdiction to implement significant amendments in respect of consumption taxes based on e-commerce issues outlined in the OECD guidelines (Van der Merwe, 2004). Therefore, the amendments made by the European Union will be observed and noted.

### **3.3. European Union**

#### **3.3.1. Classification of transactions in the European Union**

Concerning this research and the discussions to follow, it is necessary to understand the classification of transactions done by the European Union, because relevant sets of rules that are radically different will apply to different transactions (Parrilli, s.a.). Business-to-customer and business-to-business transactions will be the two types of transactions that will be discussed.

For business-to-customer transactions, also known as B2C, the private individuals within the European Union purchase items online from businesses (Bleuel & Stewen, 2000). This term generally refers to businesses selling to the public for their private use through any electronic platform (European Parliament, 2012). The B2C group is a much newer area and largely equates to electronic retailing over the Internet. This category has expanded greatly in the late 1990s with the growth of public access to the Internet. The B2C category includes electronic shopping, information searching (e.g. railway timetables), but also interactive games delivered over the Internet. Popular items purchased via electronic retailing are airline tickets, books, computers, videotapes, and music CDs (Henbury, 2001).

Business-to-business transactions, also known as B2B, refer to the commerce between companies covering all transactions within the supply chain, except the final sale to the end consumer (European Parliament, 2012). The B2B group includes all applications intended to enable or improve relationships within firms and between two or more

companies. In the past, this has largely been based on the use of private networks and Electronic Data Interchange (EDI). Examples from the B2B category are the use of the Internet to search product catalogues, ordering from suppliers, receiving invoices and making electronic payments. This category also includes collaborative design and engineering, and managing the logistics of supply and delivery (Henbury, 2001)

### **3.3.2. First attempts by the European Union – Council Directive 2002/38/EC**

The year 1999 was the year in which e-commerce is said to have received large investments in Europe and 2000 was expected to bring evidence of the first fruits of those investments. What made e-commerce appear big in 1999 was that some companies began to show new e-commerce sites for the first time, and these included both traditional companies and new dot.com companies (Kraemer & Dedrick, 2000). The e-commerce market was evolving quickly and is increasingly demanding in terms of both innovative business solutions and consumers' expectations (European Commission, 2012).

Therefore, in June 2000, in view of the impending losses of turnover tax, EU commissioner Frits Bolkestein proposed to the EU Commission to tax online transactions. The proposal is based on groundwork for guidelines done by the OECD and with the consent of all the major industrial nations (Bleuel & Stewen, 2000).

According to the EU, the current VAT rules do not adequately address the supply of services delivered online by digital means, notably with regard such services traded between EU and non-EU countries. Such supplies were simply not envisaged at the time the current VAT legislation was established (Jones & Basu, 2002). The taxation rules in force did not take account of technological progress in the delivery of services and changes were necessary in order to prevent loss of tax revenue and distortion of competition resulting from the current legislation (European Commission, 1999).

The European Commission's approach to the question of taxation of e-commerce has therefore been motivated by two factors – the protection of tax revenue and ensuring that the development of e-commerce in the EU was not hindered by a distortive or disadvantageous tax regime (European Commission, 1999).

It was regarded in the proposal made by the EU commissioner that all online turnovers will be treated in accordance with the OECD agreement, in other words as 'services' (this includes digitalised books and music, as well as computer software and pay-tv) (Bleuel & Stewen, 2000).

As a result, the application of the current VAT rules to electronically delivered services produces discriminatory results. The main purpose of the proposals is to ensure that services supplied via electronic networks for consumption within the EU are subject to VAT and that services for consumption outside the EU are exempt (Jones & Basu, 2002).

The first attempts to establish the EU rules on taxation of Internet transactions were made by the Council Directive 2002/38/EC of 7 May 2002. This Directive for the first time laid down specific rules for the regulation of e-commerce transactions. It has also made the EU the first tax jurisdiction to implement significant amendments in respect of consumption taxes based on e-commerce issues outlined in the OECD guidelines (Van der Merwe, 2004).

In terms of the sixth VAT Directive, the rules that are applicable for the place of taxation were determined to be based on the origin principle. The main regulation to determine the place of taxation for services as per the origin principle was stated in Article 9(1): *"The place where a service is supplied shall be deemed the place where the supplier has established his business or has a fixed establishment"*.

The task of the Directive 2002/38/EC, which was implemented to amend the sixth VAT Directive, was to level the playing field by introducing a definition for electronically supplied services and moving the place away from the origin principle (Korpusov, 2011).



The EU believed that this would remove the competitive disadvantage that EU companies suffered against non-EU suppliers of digital services, which gave rise to distortions in the internal market (Van der Merwe, 2004).

Based on the definition of the origin principle in Article 9(1), the implication was that for many services bought by households and unregistered traders the place of supply is the location of the supplier. This meant that transactions from non-EU suppliers were free from VAT in the European Union (McLure, 2003).

At the same time, transactions from EU suppliers were burdened with VAT regardless of the destination of transactions and status of customers. Therefore, for EU customers, it was advantageous to purchase from non-EU suppliers, because their price was VAT excluded and, all other things being equal, cheaper than the price from EU suppliers (Korpusov, 2011). This rule, which may have been satisfactory when initially adopted, has become increasingly untenable, as it places EU-based service providers at a competitive disadvantage in both EU and foreign markets (McLure, 2003).

In order to remove the competitive disadvantage, the Directive 2002/38/EC provided for three major rules related to e-commerce taxation.

The first rule relates to the illustrative list of services in a new annexure (Van der Merwe, 2004), which was characterised as ‘electronically supplied services’ for the purposes of taxation. Therefore, the classification of digital products as ‘electronically supplied services’ became a permanent rule (Pronina, 2011). Extending this list may appear to be one, simple and direct method of ensuring that it covers what the European Commission wishes to tax at the place of consumption; however, this approach carries the risk of needing to revise the list every time a new type of service is presented or every time technology yields a new way of delivering or presenting services. Furthermore, the continued phenomenon of convergence in both technologies and services is likely to mean that the terms and definitions valid today will become increasingly questionable.

There are sound reasons therefore for saying that the ‘list’ approach is fundamentally flawed and should be replaced by some more general measure (European Commission, 1999).

The second rule intended to eliminate the competitive advantage of non-EU suppliers of electronic services as compared to European sellers (Pronina, 2011). Because the EU wanted to move away from the origin principle, the Directive 2002/38/EC implemented new place of supply rules for electronically delivered services supplied (Van der Merwe, 2004). While EU suppliers were excluded from the duty to charge VAT on services exported on the markets outside the EU, non-EU vendors were obliged to charge VAT on services provided to European Consumers (Pronina, 2011).

These non-EU suppliers have to register for VAT purposes in at least one union member state of their choice, which is then referred to as their ‘member state of identification’, and all VAT compliance is controlled through that country. The country of identification will in turn reallocate the VAT revenue to the country of consumption, namely the ‘member state of consumption’ (Steyn, 2010). This regulation would only be directed at enterprises that have annual turnovers within the EU exceeding €100 000. All other businesses would be exempted for VAT purposes (Bleuel & Stewen, 2000). The non-European company will deal only with the tax authorities of the member state where it is registered, and in particular it shall submit by electronic means to the member state of identification a VAT return for each calendar quarter, whether or not electronic services have been supplied. However, the consequence of this system is that companies will choose a member state for registration with the lowest tax rate applicable to the respective service to be supplied (Parrilli, s.a.), for example Luxemburg, where the VAT rate is 15% (Pronina, 2011).

The third rule, established by the Directive 2002/38/EC, concerned the definition of the ‘place of supply’ for the services provided electronically. This rule dealt only with the services provided by non-EU vendors to European non-taxable persons (i.e. consumers). The directive established that the ‘place of supply’ for such B2C transactions should be

the place where the European consumer “is established, has his permanent address or usually resides” (Pronina, 2011).

The Directive 2002/38/EC showed substantial progress in the direction of modifying VAT rules to regulate e-commerce taxation (Pronina, 2011). This required the member states to bring into force the laws, regulations and administrative provisions necessary to comply with this Directive on 1 July 2003 as the Directive was already adopted by the Council of the European Union on 7 May 2002 (Alexiou & Morrison, 2004).

The EU directive was immediately condemned as unfair and inconsistent with economic neutrality and other principles of international taxation (McLure, 2002). For instance, a European Company established in Luxembourg would collect VAT at the rate of 15% when it supplied an electronic service to a Danish customer. However, a US company that is registered in Luxembourg and sold digital software to the same customer, would pay VAT at the rate of 25% (the standard VAT rate in Denmark) (Pronina, 2011). This became possible because the EU suppliers of electronic services are not affected by the Directive and therefore the place of supply of their services is determined by where they are established rather than by where their customers are located (Pastukhov, 2007). The difficulties that the Commission’s proposals should encounter are inevitable, as they combined several inconsistent elements in one package. The inconsistent elements were identified as:

- destination-based taxation of goods is implemented; however, origin-based taxation will be applicable for services provided to consumers and unregistered traders from other member states (McLure, 2003); and
- similar services provided from outside the EU are taxed at a rate that the service provider can choose by registering for VAT purposes in the EU country of preference (McLure, 2003). This inconsistency appeared when the Act required a vendor to register for VAT purposes in the European Union; however, the option was left to the vendor in which EU member state they would like to register. This had the implication that some non-EU vendors would register in a member state with a lower VAT rate in comparison to other member states.

### **3.3.3. Recast of the sixth VAT Directive – Directive 2006/112/EC**

In November 2006, the European Council of Finance Ministers adopted a new EU VAT directive 2006/112/EC, which revised or recast both the first and the sixth EU VAT directives, to reorganise the provisions and set them out in a clearer way (Seely, 2012). The sixth VAT Directive was replaced because it had become too tangled and complicated due to the amendments and recasts that were implemented because of the changes in the European Union in last 39 years and the evolution of technology (Van der Merwe, 2004). This was also done to reduce the inconsistencies identified in section 3.3.2. The VAT Directive 2006/112/EC consolidated all the changes and amendments made to the sixth Directive, including the Recast VAT Directive, together in one document in order to simplify the taxation legislation (Korpusov, 2011). The Act incorporated all the amendments made to the sixth Directive by subsequent acts and any relevant provisions previously to be found in separate legal acts (Terra & Kajus, 2012).

The VAT Directive 2006/112/EC is effectively a recast of the sixth VAT Directive of 1977 as amended over the years. The sixth Directive had been in force in the European Union for 39 years and, in 2006, was repealed by the Recast VAT Directive (Korpusov, 2011).

It developed from ‘supplementary’ sector-specific Directive 2002/38/EC, which was the starting point in the regulation of e-commerce and which had to be read in conjunction with the first and sixth VAT Directives. To clarify and rationalise the structure and the wording of the legislation, a new Recast VAT Directive was adopted. It brought no new principles or changes into the regulation in terms of the place of supply rules for VAT on e-commerce transactions, therefore all rules remained unchanged (Korpusov, 2011).

The EC VAT Directive was meant to have no impact on substantive content, but merely restructured and updated the EC’s VAT law (PWC, s.a.).

#### **3.3.4. Implementation of Reverse Charge – Directive 2008/8/EC**

The Council Directive 2002/38/EC, which was recast in the Council Directive 2006/112/EC, did not solve the problems relating to the application of VAT to the rapidly developing e-commerce, as the rules remained unchanged for VAT on e-commerce transactions. Therefore, the need for new rules continued to be present (Pronina, 2011).

Following the Commission's strategy of modernisation and simplification of the operation of the common VAT system, the proper functioning of the internal market required the amendment of Council Directive 2006/112/EC of 28 November 2006 on the common system of VAT regarding the place of supply of services (Loquet, 2011). The internal market discussed can be defined as "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the EC Treaty" (De La Feria, 2009). These changes in the VAT system were necessary because of the realisations in the internal market, globalisation, deregulation and technology changes, which created enormous changes in the volume and pattern of cross-border services (Schoorl, 2010).

Council Directive 2008/8/EC was adopted on 12 February 2008 (Revenue Commissioners, 2011). The aim of the Directive was to combat tax evasion connected to intra-community transactions (Zeippen & Verschaffel, 2012). The Council Directive 2008/8/EC established new taxation rules for both B2B and B2C transactions (Pronina, 2011). Therefore, since 1 January 2010, new rules on the place of taxation of services applied (Zeippen & Verschaffel, 2012).

For B2B transactions, a new mechanism called 'reverse charge' was established. Reverse charge is when the liability to pay VAT is shifted from the supplier to the recipient of the supply. According to the reverse charge mechanism, it is the customer, which is the person to whom the goods or the services are supplied, who must pay and account for the VAT, not the supplier (Bal, 2011).

The Directive, however, established differential treatment for the B2C transactions where the supplies are made by the vendors from outside the EU compared to supplies made by European operators (Pronina, 2011).

Although non-EU operators supplying services to European consumers were not responsible for the consumption tax, VAT was still paid, because European recipients of electronic services were obliged to account for VAT using the reverse charge mechanism (Scheer, 1999). On the VAT return, the recipient accounts for the VAT he/she is obliged to pay according to the reverse charge mechanism. However, the recipient can also account for it as an input VAT on the same VAT return, which will lead to no VAT payment or any claim for repayment (Lúðvíksson, 2012).

The new scheme appears to be very efficient for B2B transactions (Pronina, 2011). With the establishment of the reverse charge mechanism for B2B transactions, the process of tax collection was simplified significantly (Pronina, 2011). Reverse charging effectively reduces suppliers' compliance burden by shifting the liability to assess and remit the correct amount of tax to business customers, who are registered for VAT purposes and comply with their tax obligations on a self-assessment basis via their periodic returns. It reduces administrative costs for tax administrations, as there is no handling of a large number of registrations for a limited number of taxable supplies in their territory (Lamensch, 2012).

However, in contrast, there are potential interruptions that reverse charging creates in the VAT chain. Reverse charging indeed suspends suppliers' VAT liability in all transactions preceding the retail stage and therefore more or less transforms the VAT into a retail sales tax as found in most US states and some Canadian provinces (Cnossen, 2008).

The reverse charge mechanism was not considered a practical solution for B2C transactions (Pronina, 2011). For B2C supplies, reverse charging is not a viable option to use, because consumers are not registered and have neither the skills to voluntarily proceed to the remittance of the tax nor any incentive to do so given that, unlike businesses, they have to bear the economic burden of the tax without any possibility of recovering it (Lamensch, 2012).

Because reverse charge was not believed to be an efficient option for B2C e-commerce transactions, different rules were established for the VAT treatment. The temporary rules established by the Council Directive 2002/38/EC were considered to be working effectively and were extended for the supplies made by the vendors from outside the EU. All non-EU vendors are required to register in one of the member states and pay VAT at that state for all supplies to European consumers based on the tax rates of the countries of consumption. According to these rules, a European company that is established in one member state and supplies electronic services to the consumers in other member states is required to pay VAT only to its local tax authorities at the tax rates of its own member state (Pronina, 2011).

The VAT legislation was further extended when an additional regulation was established where electronically supplied services were defined by the European Union.

### **3.3.5. Defining electronically supplied services – Regulation 2011/282**

Because the EU has a special VAT regulation for e-commerce, it was important to define digital goods and services in order to establish which section of the tax legislation will be applicable (Korpusov, 2011). This is a big advance for the EU tax legislation by defining e-commerce transactions or electronic supplies services, as there was a void in the current tax legislation.

The EU has defined electronically supplied services in its Regulation 2011/282 as “Electronically supplied services” as referred to in Directive 2006/112/EC shall include

services which are delivered over the Internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology” (European Commission, 2011).

### **3.3.6. Future expectations**

Article 45 of the Council Directive 2006/112/EC stipulates that, as the general rule for services, the place of supply to private customers should be the place where the supplier is established. Nonetheless, this rule applies only to transactions from EU suppliers to EU private customers and is in force until 1 January 2015 (Korpusov, 2011). From 1 January 2015, the origin principle will be eliminated (Pronina, 2011). New rules will be applicable, which will require each European company supplying services to the consumers from other member states to remit VAT at the tax rates of the country of consumption. In other words, European suppliers will have to pay VAT to the authorities of its own member state, but based on the differential VAT rates determined by the tax legislation of the recipient’s member state (Pronina, 2011).

These new rules, although not yet effective, will be of great importance for the EU e-commerce taxation. It will solve primarily the issue of ‘non-neutrality’ between European vendors and suppliers from outside the EU (Pronina, 2011).

With regard to telecommunication, broadcasting and electronic services, the introduction of the new rules on the place of taxation of business-to-consumer supplies has been delayed until 1 January 2015. From that date, these services will be taxed in the country where the consumer is established. Suppliers will be permitted to discharge their VAT obligations using a ‘one-stop shop’ scheme that will enable them to fulfil their VAT obligations, consisting of registration for VAT purposes and the declaration and payment of the tax, in their home member state, including for services provided in other member states where they are not established (Zeippen & Verschaffel, 2012).



From 1 January 2012, France and Luxemburg imposed VAT on e-books at the rates of 7 and 3%, respectively, to align their rates with those applicable to paper books. This is primarily substantially lower than the average rate of VAT on electronically supplied services in the EU. In October 2012, the Commission issued a consultation paper entitled Review of existing legislation on VAT reduced rates. One of the principles set out in the paper is that: “Similar goods and services should be subject to the same VAT rate and progress in technology should be taken into account in this respect, so that the challenge of convergence between the online and the physical environment is addressed”. The consultation document noted that previous communications from the Council and other documents have recognised that in the current economic environment reform of VAT should focus on removing unjustified exemptions and broadening the tax base. Limiting the use of reduced rates is a way of broadening the tax base and for this reason the document somewhat exhibits a bias towards the abolition of reduced rates rather than any extension of their application (Morton, 2013).

### 3.3.7. Summary of the European Union VAT on e-commerce transactions

Based on the above, the following can be summarised on the developments in the European Union in terms of VAT on e-commerce:

Table 3: Summary of developments in European Union VAT system regarding VAT on e-commerce transactions

<b>VAT Directive</b>	<b>Year</b>	
<b>Council Directive 2002/38/EC</b>	2002	The first changes made to VAT on e-commerce. Based on this directive, the place of taxation was changed from the origin principle to the destination principle for B2B transactions; however, for B2C transactions, the origin principle was still applicable. There was also a list of items supplied that were considered to be electronic services supplied.
<b>Directive 2006/112/EC</b>	2006	A recast of the sixth VAT Directive was made because the sixth VAT Directive became too tangled with all the additional Directives added for changes.
<b>Directive 2008/8/EC</b>	2008	In this Directive, the reverse charge mechanism was introduced on B2B transactions in the European Union.
<b>Regulation 2011/282</b>	2011	The Directive was issued to supply a definition of electronically supplied services for VAT purposes.

As can be seen from above, the European Union had many changes over the last few years on the VAT rules for e-commerce. They are still trying to perfect the VAT system to ensure that nobody is at a disadvantage in terms of VAT on e-commerce and to promote neutrality. There were many developments in the European Union in terms of their VAT system and lessons can be learned from the amendments implemented by the European Union.

Although the European VAT system is considered relatively similar to the South African VAT system, New Zealand's GST system is considered superior to the EU VAT system in tax literature (Copenhagen Economics, 2013). It has been concluded that the changes that New Zealand made when introducing its VAT in the mid-1980s were an improvement on the European model. Countries seeking to introduce VAT have often been advised to consider New Zealand's approach, and many countries have done so (Dickson & White, 2008). Moreover, the VAT legislation in South Africa is based on the New Zealand legislation (Glyn-Jones, 2006). South Africa initially followed the New Zealand GST when it enacted its VAT regime in 1991 (Merrill, 2011). Therefore, the developments in New Zealand's VAT system over the last few years in terms of VAT on e-commerce will be considered.

### **3.4. Development of VAT on e-commerce transactions in New Zealand**

Australians, like Canadians and New Zealanders, call their indirect tax on goods and services Goods and Services Tax, also known as GST. However, their GST fits the VAT mould: it is a credit-invoice method, destination-based consumption tax with limited tax base exclusions (Morse, 2011).

Often referred to as the "Goods and Services Tax", Value Added Tax is distinctly different from the General Sales Tax levied on exchanges (Anon, 2010). Confusion may be caused because the acronym for General Sales Tax is also GST; however, General Sales Tax differs significantly from Goods and Service Tax.

Value Added Tax or Goods and Services Tax is a form of indirect tax that is imposed at different stages of production on goods and services. VAT will be levied on the importation of goods and the same rate will be maintained as that of the local produce. Most of the European and non-European countries have adopted this system of taxation. The transparent and neutral nature of taxation has prompted VAT to emerge as one of the robust revenue raisers in these countries (Anon, 2010).

Sales tax, as compared to VAT, is the percentage of revenue imposed on the retail sale of goods. Unlike VAT, sales tax is levied on the total value of goods and services purchased (Anon, 2010).

The New Zealand Goods and Services Tax (GST) is a broad-based, consumption-type value-added tax that is collected and remitted to the government by businesses at every stage of the production and distribution process (White & Trombitas, 2012). This is similar to the VAT systems of the European Union and South Africa. When referring to GST further in this chapter, it should be noted that it is a referral to Goods and Services Tax.

Electronic commerce transactions hold much potential for New Zealand's economy, but for that potential to be realised, it is vital that the legal infrastructure is modern enough to cope with new challenges (New Zealand Law Commission, 1998).

In New Zealand, GST applies to almost all goods and services supplied, almost all imported goods and some imported services (White & Trombitas, 2012). Unlike imported goods, most services imported into New Zealand are not subject to GST (Pallot & Fenwick, 2000). New Zealand, therefore, unlike most OECD countries, does not subject most imported services to GST. When GST was introduced in 1986, it was decided that the tax would not apply to imports of services, even though both imports of goods and services are generally included in the GST base (Cullen, 2003). The distinction of an overseas supplier will therefore be vital, because he, she or it is not liable for GST for services supplied in New Zealand; however, there will be a liability on the goods supplied (New Zealand Law Commission, 1998). It is clear that the sections under the GST Act have been designed to cover physical imports, including digital media shipped in physical form such as DVDs, but do not cover digital items that can be downloaded from the internet (Gallagher, s.a.).

Because New Zealand service providers making supplies in New Zealand are required to charge GST, there arose competitive distortions because non-resident service providers in the same situation are not required to charge GST. New Zealand service providers were therefore at a disadvantage compared to non-resident service providers. By not taxing imports of services, the New Zealand GST system allows those services to avoid any impost of consumption tax, as such supplies would not have been taxed when exported from the jurisdiction in which they originated (Cullen, 2003).

The 1997 OECD codes of conduct, 'Guidelines for Consumer Protection in the Context of Electronic Commerce', for distance selling in the global market place recommended that electronic commerce transactions to be treated no different from any other means of commerce, also referred to in the 1997 Ministry of Consumer Affairs Report. To some extent, this approach is followed up in a recent code of practice developed by the Internet Society of New Zealand for Internet service providers (Osborne, 1999).

The potential implications for consumers in the increasing use of electronic commerce transactions has already been recognised by the Ministry of Consumer Affairs in a 1997 discussion paper, *Electronic Commerce and the New Zealand Consumer: Issues, and Strategies for the Future* (New Zealand Law Commission, 1998).

In 2000, the New Zealand Government launched its e-commerce strategy. It detailed the Government's commitment to provide leadership and to work in partnership with business and the broader community to build the e-commerce capability of New Zealanders. To date, the Government has implemented a significant number of initiatives in all these areas including:

- consumer protection such as the New Zealand Model Code for Consumer Protection in Electronic Commerce;
- legislative changes including the Telecommunications Act 2001 and the Electronic Transactions Act 2002, and proposed legislation to outlaw spam;
- education initiatives to drive uptake of e-commerce by SMEs such as the work of the E-Commerce Action Team; and
- continued rollout of e-government at the central and local government levels. (The Ministry of Commerce, China & The Ministry of Foreign Affairs and Trade, New Zealand, s.a.).

The review of the GST treatment of imported services was included in the government's tax policy work programme for 2001-2002, prompted by increased volumes of imported services. The government's e-commerce strategy, as set out in the strategy paper *E-Commerce: Building the Strategy for New Zealand*, also identified addressing the GST treatment of imported services as a key part of ensuring that New Zealand's regulatory environment takes into account electronic commerce transactions (Cullen, 2003).

On 27 June 2001, the Government released a tax policy discussion document addressing the GST treatment of imported services – *GST and imported services: a challenge in an electronic commerce environment*. This document proposed the introduction of a ‘reverse charge’ mechanism to tax imports of services by businesses (Cullen, 2003). The reverse charge mechanism was implemented from 1 January 2005. It was implemented because, in the absence of GST on imported services, it discourages the domestic production of services, since domestic producers may not be able to pass on the GST cost to consumers, who are able to switch to imported services that are not subjected to GST (Pallot & Fenwick, 2000).

A ‘reverse charge’ requires the recipient of a supply to return GST to Inland Revenue, as if the recipient was the supplier of that supply (Sussman, 2001). To minimise compliance and administrative costs for businesses, the reverse charge would apply only to those businesses that acquire services for other than taxable purposes (Cullen, 2003), in other words, where the recipient would not have been entitled to recover all of the GST charged to it had the supply been acquired from a GST-registered supplier (Sussman, 2001). The reverse charge is intended to alleviate the current distortion in favour of imported services created by the non-taxation of imported services compared to the taxation of domestically supplied services (Cullen, 2003).

By implementing the reverse charge mechanism, it aligned New Zealand’s GST system with that of most other countries with a VAT or GST system and the treatment of services with that of goods (Cullen, 2003).

A compulsory reverse charge regime applies effectively from 1 January 2005 if all of the following circumstances exist:

- A supply of services is made by a non-resident to a resident.
- The supply would be taxable if made in New Zealand.
- The recipient of the supply is registered (or required to be registered).
- The recipient makes taxable supplies that total less than 95% of the recipient’s overall supplies (Ernst & Young, 2012).

The reverse charge is 15% of the consideration for the supply. An input tax credit may be claimed with respect to the reverse charge to the extent that the service was acquired for the principal purpose of making taxable supplies (Cullen, 2003).

Foreign or non-established businesses must register for GST if it makes taxable supplies in New Zealand that exceed NZ\$60 000 in any 12-month period. A non-established business may also register for GST voluntarily if its supplies are below the annual registration threshold. (Ernst & Young, 2012).

New Zealand, like any other country, has needed to define what is meant by electronic commerce transactions and then decide how it affects the law and how the law affects it (Osborne, 1999). E-commerce was defined as the buying and selling of goods and services via electronic networks, principally the Internet. Its definition is sometimes expanded to include other aspects of e-business (New Zealand Parliament, 2001).

The definition of 'goods' had to be amended so that supplies of imported digitised products, such as software provided over the Internet, will be treated as supplies of services and therefore potentially subject to the reverse charge. Therefore, supplies of services that would be exempt supplies if made in New Zealand will not be subject to the reverse charge (Cullen, 2003).

In 2002, the Inland Revenue Department released a guideline called *Guide to tax consequences of trading via the Internet*, which is still current today despite the need for the tax rate to be changed. This guide reinforces that all sales sold via the Internet in New Zealand will attract GST regardless of the amount (Gallagher, s.a.).

The proposed imported services legislation has been integrated as far as possible with the general GST provisions. The approach is based on treating certain imported services as being supplied in New Zealand and deeming the recipient of those services to be their supplier. This is in contrast to introducing a separate code, which would require far more detailed legislation as many existing provisions of the Act would need to be replicated (Cullen, 2003).



### **3.5. Conclusion**

Based on the above information obtained from the OECD framework, the European Union and New Zealand's VAT system similarities were noted.

Both New Zealand and the European Union have implemented the reverse charge mechanism on B2B transactions, which appears to work efficiently. Both have implemented the rule that foreign companies supplying e-commerce to residents should register in the countries. This is in line with the proposal made by the Minister of Finance in the 2013 Budget Speech.

Specifically, it can be seen that there are still difficulties with the VAT rules with regard to the B2C transaction in the European Union as there will be new rules implemented in 2015.

As an understanding was obtained of the VAT rules in other countries and it was identified that there are difficulties experienced, Chapter 4 will discuss what the common challenges are that are experienced in the countries when implementing VAT on e-commerce. This will indicate to South Africa what additional considerations there are when implementing VAT on e-commerce within a South African context.

## **Chapter 4     Challenges concerning VAT on e-commerce**

### **4.1.    Introduction**

In Chapter 3, an understanding was obtained of how different countries have implemented VAT on e-commerce transactions in their VAT systems. However, the implementation of VAT on e-commerce transactions was not without any challenges. These problems will be considered in Chapter 4 to identify possible challenges that may arise when implementing VAT on e-commerce in South Africa. This could indicate for South Africa what problems should be considered when adjusting the current VAT system to implement the Minister of Finance's proposal.

The problems presented by electronic commerce transactions for the calculation of VAT are not in themselves new (De Wet & du Plessis, s.a.). The mechanism of the VAT system works well where the VAT-registered supplier and recipient reside in the same country, but poses a challenge when they are situated in different countries (Badenhorst, 2013). Tax rules under domestic laws as well as treaties impose different tax treatment on different types of cross-border income (Cockfield, 2006). Each country will impose its own VAT rules, which could lead to double taxation or non-taxation of the supply (Badenhorst, 2013). It is more a question of electronic commerce transactions exacerbating existing tensions and difficulties inherent in the tax when dealing with cross-border transactions, relating particularly to the place of supply and enforcement issues for non-resident suppliers of services (De Wet & du Plessis, s.a.). Multinational enterprises are therefore able to exploit the arbitrage between the VAT systems of countries, thereby minimising their tax burden and obtaining a competitive advantage (Badenhorst, 2013). Businesses exploit the fact that there is no specific legislation governing electronic commerce and virtual world transactions (Johnston & Pienaar, 2013). Global e-commerce makes the cross-border movements in goods, capital and labour less transparent allowing companies and individuals to exploit tax differences between countries, or even to evade taxation (Jones & Basu, 2002).

The borderless nature of e-commerce makes it difficult to define where income is earned, when a product is purchased, or value is added. As a result, it is difficult to determine at what point profits are realised and which country is the recipient (IBSL Editorial Department, s.a.). The challenge facing tax administrators is to adapt existing legislation, procedures and practices to overcome any deficiencies that emerge because of new means of communication and product delivery (Owens, s.a.).

Difficulties were experienced when taxing cross-border e-commerce transactions. Over the last few years, a number of tax administration and international organisations have been studying the impact of e-commerce on tax policy and tax administration (Gillanders, 2010). The EU, however, has considerable concerns over the increasing import of digital content and services from outside the EU, which would be exempted from VAT payments in the EU. In terms of the current legislation for the European Union, foreign suppliers may be tax exempted, whereas local suppliers are normally required to charge value added tax (Teltscher, 2000). The challenges posed by electronic commerce transactions for taxation have been well documented, which include how to identify taxpayers engaged in e-commerce and to determine their taxing jurisdiction; how to ensure that appropriate records are created of business conducted by e-commerce; and how to collect taxes in the e-commerce environment (Jones & Basu, 2002). Possible challenges that countries may experience relating to taxing cross-border e-commerce transactions were identified that will be discussed in this chapter (Gillanders, 2010).

From the above, the following tax issues were identified by different countries relating to taxing cross-border e-commerce transactions, which will be considered in this chapter:

- Verifying the details of a transaction;
- Identifying the parties to a transaction;
- Determining the permanent establishment;
- The effect on the Double Tax Treaties; and
- The erosion of the tax base.

#### **4.2. Verifying the details of a transaction**

Historically, transactions were entered into with relevant source documentation that contained information such as the date, parties, products and value of the transaction. The applicable source documents are also considered reliable because they cannot easily be altered without leaving evidence of such an alteration (Du Plessis, 2006). However, e-commerce transactions have a more anonymous character than the traditional ways of commerce, because it is carried out without papers and pens, offices and warehouses, and even without employees. In such an environment, tax authorities may not easily keep track of the identity or location of the parties to a transaction concluded over the Internet (Akçaoğlu, 2002). In the physical world, the information to support the existing tax base is found in the financial records of a taxpayer or other entities such as banks and deed offices and, at the lowest level, source documents such as receipts and invoices (Du Plessis, 2006).

Many online shoppers do not feel comfortable providing unnecessary personal information to a website. Consequently, they may refuse to type it in, shop at a site that does not require it or simply provide false information. The result is an inability to tax and an erosion of the total tax base (Jones & Basu, 2002).

The move to paperless trade also presents some legal problems to the international business community (Laryea, 2001). Electronic records, such as those that might be produced in an e-commerce environment, are not as robust (Du Plessis, 2006). Without the appropriate controls, electronic records are more easily forged than traditional paper documents and their true origin more difficult to establish (Cohen, s.a.). Electronic records can be altered without trace and therefore the reliability of these records may be more questionable (Du Plessis, 2006). Moreover, electronic records may be more easily destroyed or altered than paper records without leaving evidence of such destruction or alteration (Cohen, s.a.). Although the paper source documents can also be altered, it is not as easy to alter the documents without leaving evidence of such an alteration (Du Plessis, 2006). E-commerce leaves less of a 'paper trail', such as invoices and receipts, which tax authorities often use to track down and verify conventional transactions, and even when electronic records are available, they are more

subject to tampering than paper records are (McClure, 1997). This is often referred to as the dematerialisation problem (United Nations Conference on Trade and Development, 2003). As all users of computers know, this creates the possibility for tax evasion and fraud due to the easy alteration of computerised records (Chang & Yen, 2000).

Although many taxpayers rely largely on computerised record-keeping systems, many transactions are still originated as paper records, which can be used to verify the accuracy of the electronic records. However, for taxpayers engaged in the sale of electronic goods or services, no physical records are likely to be created because customer orders are placed and completed electronically and therefore the only record that exists of these transactions could be an electronic one. It is also questionable whether the evidence that tax administrators would be able to produce on transactions that take place in cyberspace would satisfy the documentation and evidence standards set by tax laws (Pinto, 1999). Moreover, an encrypted electronic record might not reveal any information about the value of a transaction (Du Plessis, 2006).

The possibility of changing details on the invoice also relates to the avoidance of tax, as will be discussed in section 4.3. If there is no real distinction between items, or you can easily substitute one item for another, taxpayers have an incentive to favour whichever item is taxed the least (European Parliament, 1999). In Chapter 2, it was discussed whether e-commerce can be defined as goods or services. Although it was concluded in Chapter 2 that e-commerce should be treated as services, not all countries apply the same basis. The more numerous and diverse the characteristics and attributes of particular items, the easier it is to tax them differently (European Parliament, 1999).

As seen above, the risk exists that there may be alterations made to source documentation relating to information regarding the products or services and the relevant parties of the transaction. The most essential qualities of a record are that it is authentic and that its content is fixed over time. In other words, people must have confidence that a record is what it says it is. Electronic records, unfortunately, do not intrinsically inspire this confidence in the same way that paper records do. The ease with which electronic documents can be created, altered,

accessed, duplicated, and shared jeopardises their value as records (NECCC, 2004). Therefore, the customer can alter the documentation in such a way to pay minimum tax and VAT to authorities; for example, stating that a service was provided rather than product to parties from tax havens. E-commerce transactions make it difficult to obtain reliable transaction information, which is necessary to determine the value of the taxable element of a transaction (Oguttu & Van der Merwe, 2005). Furthermore, it is important for the tax authorities to verify the parties that are involved in the transactions as stated on the documentation in order to determine the place of supply and the relevant tax legislation applicable.

#### **4.3. Identifying the parties to a transaction**

As discussed in the previous section, it has been identified that the validity of information on electronic documents may pose to be a challenge. In order to enforce taxation laws, it is essential to ascertain where the e-commerce transaction has taken place and between whom (Pinto, 1999). The identification of the parties and location of the transaction are therefore interlinked with the information obtained from the records relating to the e-commerce transaction. Moreover, the determination of the location is of crucial importance in order to determine whether a transaction has a taxation effect or not. When a company is supplying cross-border services, it is important to understand in which country this service is subject to VAT (Praxity, 2013) in order to apply the correct VAT principles to the transaction.

Based on the above challenges identified, the question whether a certain e-commerce transaction has tax implications or not, will currently largely depend on the honesty of the participating parties (Krensel, 2005).

To determine the country in which the service will be subjected to VAT, the parties of the transaction need to be identified to determine the place of supply and the place of consumption. Where an order is placed through the Internet, it may be difficult to identify and locate the parties to the transaction, especially if the customer is a private consumer (Van

der Merwe, 2003). Moreover, the Internet offers a great deal of anonymity and, furthermore, the OECD has described anonymity as one of the great challenges (Krensel, 2005).

The reason for the difficulty in identifying the parties is that electronic commerce transactions on the Internet are decentralised and do not take place at any physical location (Pastukhov, 2007). Currently, the links between activities on the Internet and the physical parties associated with the Internet are weak (Du Plessis, 2006). E-mail addresses and Internet domain names can hide the identity of the parties; and the location of a party may not at all be detectable (Pastukhov, 2007). The composition of an Internet address, or domain name, only indicates who is responsible for the maintenance of that name. It has no relationship to the computer or user corresponding to that address or even where the machine is located. Moreover, in e-commerce, there is not necessarily any relationship between an Internet address and a physical location (Du Plessis, 2006).

Therefore, taxing the online sales of intangible products is problematic because the location of customers cannot always be known with certainty (Jones & Basu, 2002). There is also currently no facility to determine the owner of an existing website. Furthermore, monitoring Internet sites is not an option, as they may not leave a trail to the ultimate owners. The owners could use fictitious names or complex networks to hide the existence or location of websites (Du Plessis, 2006). Verifying the identities of parties to a business transaction may be difficult in the world of e-commerce (Pinto, 1999).

It has been pointed out that the Internet removes the need to be in the physical presence of your business party; however, what is more, it also removes the need to reveal your actual identity and location. If tax authorities cannot trace a taxable transaction, identify the buyer, seller, the relevant locations, and obtain access to verifiable financial records of the taxpayer, the levying of VAT will prove difficult and compliance may not be enforced. Taxpayers are likely to use the superficial anonymity offered via the Internet to conceal their commercial activities and escape taxation, and this poses a real threat to national tax bases and puts businesses that play by the rules at a disadvantage (Fridensköld, 2004).

Another concern relating to the anonymity of the parties is the need to verify the identity of counter-party for double tax treaty purposes. For example, a seller of electronic information may claim to be a resident of a treaty country and thereby entitled to a reduced or zero rate of withholding tax on royalties (Du Plessis, 2006). Double tax treaties will be discussed in more detail later in 4.4.2 below.

The Committee for Fiscal Affairs of the OECD has responded to this issue by recommending that revenue authorities may consider requiring that businesses engaged in electronic commerce transactions identify themselves to revenue authorities in a manner that is comparable to the prevailing requirements for businesses engaged in conventional commerce in a country (Pinto, 1999). However, the authorities will need to think carefully before responding to this problem by instituting identification and registration requirements as it is likely that such requirements will have limited success due to the growing ease with which websites can be located offshore.

From the above, it is clear that the mechanisms to trace identity are weak, in that it is a relatively simple matter to arrange for the untraceable use of an Internet website (Owens, 1999). Without accurate identification of taxpayers, it is difficult to levy taxes. Even if you can identify the taxpayer, but not its physical location in the world, this will give rise to jurisdictional disputes between tax authorities, with all the attendant risks of double taxation (Jones, s.a.). When the parties of the transaction are determined, the place of supply needs to be determined in order to indicate which party is liable for reporting and paying the VAT due to the relevant tax authorities (Praxity, 2013).

#### **4.4. Permanent establishment**

As mentioned in the previous point, the next issue to be considered is the determination whether a taxable transaction arises, and if so, in which jurisdiction that transaction should be taxed (Pinto, 1998). Establishing the location of the transaction is essential to apply the correct rules and rates, and paying the tax to the relevant country.



A fundamental problem posed by e-commerce is the identification of the country or countries that have the jurisdiction to tax transaction income (Du Plessis, 2006). As the use of technology has increased, the connection between the location of the service provider and the location of the consumer has become less significant (BIAC, 1999).

The essence of electronic commerce transactions is that transactions are carried out without having any relation to national or geographical borders. Due to the advent of the Internet, cross-border commercial transactions can be enabled by computer servers (i.e. a computer that has been networked to the Internet) instead of traditional business intermediaries such as retail stores (Cockfield, 2006). E-commerce does not occur in any physical location, but instead takes place in cyberspace. Parties engaged in e-commerce could be located anywhere in the world, and their customers will be ignorant of, or indifferent to, their location (Du Plessis, 2006). Moreover, with the present technology, digitised products cannot be stopped and checked at the customs, while they are transferred from one country to another via the networks (Akçaoğlu, 2002).

In order to be taxable in a specific jurisdiction, certain connecting factors need to be present. Traditional principles of international income tax are closely tied to the question of physical presence (Du Plessis, 2006). The problem is created that the services or products ordered via the Internet may be supplied from unknown locations for the purchaser and by different entities that, because of being located in different countries, have combined activities (Van der Merwe, 2003).

However, because of the unknown locations and different entities, the problems arise with companies that trade online and sell goods in another country, if the place where their permanent establishment is situated differs from their online establishment. For example, a company XYZ Ltd may be incorporated in South Africa (a South African resident by definition) and decides to establish its online business through a server in America (Stelloh & Stack, 2007). The challenge is which country or countries may tax the South African company's business profit on the sale to a foreign customer, for example from Australia (Stelloh & Stack, 2007).

This example illustrates how difficult it can be to apply the concepts of permanent establishment, residence or source in order to tax the transaction (Stelloh & Stack, 2007). Individuals and entities engaging in electronic commerce transactions will be able to create an Internet address in almost any taxing jurisdiction irrespective of the location of their residence or the source of their activities (Pinto, 1998). Moreover, enterprises carrying on business in multi-jurisdictions have the ability to move their businesses from one country to another, in a matter of hours. They can locate their business in a country beyond the reach of other countries' tax authorities because the Internet servers can be located anywhere in the world (McLure, 1997).

In addressing the aforementioned, the OECD has amended Article 5 of the OECD Model Tax Treaty to clarify the interpretation of the permanent establishment concept in the circumstances of uncertainty. An Internet website (a combination of hardware, software and data) does not in itself give rise to a permanent establishment, although the hosting server may under certain circumstances (Du Plessis, 2006). The commentary concludes that equipment, standing alone, could constitute a "fixed place of business". In describing the complete analysis of whether such a place of business could constitute a permanent establishment, the commentary expresses several important principles (Sprague, 2013). Software and data constitute intangible property and therefore do not have any specific location. It therefore follows that they also cannot have a "place of business", as required by the treaty. On the other hand, a server consists of computer hardware that has a location and may under certain circumstances constitute a fixed place of business. Furthermore, the commentary notes that some uses of the equipment might constitute preparatory or auxiliary activities. If the only use of the computer equipment is to conduct such preparatory or auxiliary activities, then the computer equipment, while it still may constitute a fixed place of business, does not create a permanent establishment on the basis that the business of the enterprise is not carried on through that place (Sprague, 2013). When a company complies with the requirements as set out in the OECD model, a server may give rise to a permanent establishment (Du Plessis, 2006). When the permanent establishment is determined, the applicable country will be able to impose VAT on the company's sales.

In addition, other factors still need to be determined relating to the Internet servers, for example whether they are fixed in nature and whether the servers were in the specific location for a sufficient amount of time. As it is often with taxation, this will be considered within the context of a specific set of facts and circumstances (Du Plessis, 2006).

Furthermore, the correspondence, between the Internet address (the computer 'domain name') and the location where the activity is supplied, carried out or consumed is tenuous: although the address will tell you who is responsible for maintaining that site, it may not tell you anything about the computer that corresponds to the actual Internet address, or even where that machine is located (Owens, 1999).

Consensus must be reached on the question of which country has the right to collect the VAT from a particular transaction, so that double taxation or unintentional non-taxation is prevented from occurring (Fridensköld, 2004). Double tax treaties were implemented between countries to prevent double taxation. However, as discussed above, it is difficult to determine the location of the e-commerce transactions and this will pose a challenge for double tax treaties to prevent double taxation. In the following section, a better understanding will be obtained of double tax treaties and the possible challenge originating from e-commerce transactions.

#### **4.5. Double tax treaties**

'Double taxation' has been defined as "the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods" (Vann, 1998). Double taxation can arise from dual residence conflicts between countries using different tests of residence under their domestic laws (Akçaoğlu, 2002). To prevent double taxation, tax treaties were implemented. Tax treaties provide residents of a state with certainty on how their income will be taxed in the other state, which, in turn, encourages international trade. The purpose of double tax treaties is primarily to avoid double taxation of residents of the two states and to prevent fiscal evasion (Du Plessis, 2006).

It is believed that the existing tax treaty network can accommodate the changes in the way that international commerce is conducted; however, minor modifications to the definitions in those treaties may be required to clarify their application to electronic commerce transactions (BIAC, 1999). Tax treaties should continue to serve the purpose of reducing double taxation by minimising the income tax burdens of non-resident taxpayers in the host country. This is a crucial consideration in the removal of tax obstacles from cross-border commerce (both in its traditional and electronic form) (BIAC, 1999).

Generally, tax treaties affect source base taxpayers by narrowing the scope of taxability in the source country (BIAC, 1999). As discussed in section 4.4 above, there are difficulties to determine the correct place of supply and whether there is a permanent establishment. Therefore, the application of a permanent establishment in an e-commerce environment is not that clear (Du Plessis, 2006). Moreover, double tax treaties are bilateral and generally cover income and capital taxes (Du Plessis, 2006). It should be taken into consideration that the existing double tax treaties are not covering VAT or other consumption taxes as they are excluded. Without double tax treaties, the international community has only avoided double taxation thus far by establishing a general principle, which states that the state of consumption shall be entitled to tax the consumer (Krensel, 2005).

Therefore, a key concept of any double taxation treaty is that of a permanent establishment. A permanent establishment is the concept used to determine under a double tax treaty whether a resident of one state has a taxable presence in the other contracting state (Du Plessis, 2006). However, it was already identified with electronic commerce transactions that it is very difficult to apply the source principle in order to link a transaction to a certain geographical location (Stelloh & Stack, 2007). It is already getting more difficult to apply the current tax treaties and the general principles of the Income Tax Act. Moreover, as the tax treaties do not specifically address consumption taxes on transactions, there is a void in the tax treaties between South Africa and other countries and this create challenges for all consumption tax transactions. The current tax treaties should be reconsidered and possibly include changes relating to e-commerce transactions and consumption taxes.

#### **4.6. Erosion of tax base**

When compounding the problem of the existence of an audit trail as discussed in section 4.1 above, the fact is that the Internet makes it difficult for countries to keep track of income generated in their territory, since no government can be aware of all or even most of the websites in the world that offer products or services to their residents (McClure, 1997). This will lead to the erosion of the tax base for countries. The erosion of the tax base can be defined as the shifting of profits in ways that decrease the taxable base to locations where it is subject to a more favourable tax treatment (OECD, 2013). The Internet may drain governments' tax revenues either by making evasion easier or by encouraging economic activity to shift to lower-tax countries (European Parliament, 1999).

The erosion of the consumption tax base resulting from e-commerce has caused considerable concern among governments, given the steep growth of e-commerce in the past years and predictions for the next few years. Differentiated Internet taxation rules among countries could have a significant impact on consumers' purchasing behaviour, shifting from domestic to foreign suppliers. Foreign suppliers may be tax-exempted, whereas local suppliers are normally required to charge value added tax (VAT) or sales taxes (Jones & Basu, 2002). The erosion of the tax base is caused by the tax evasion and tax avoidance, which is an integral problem relating to e-commerce transactions.

Tax authorities have always contended with problems such as tax evasion and tax avoidance (Basu, 2008). Moreover, the problems relating to tax avoidance and tax evasion have increased and are considered to be important issues when it comes to concerns about tax compliance in relation to e-commerce transactions (Westberg, 2002). Electronic commerce could result in an increase in tax avoidance schemes. With international offline transactions, customs were able to check the import and export of goods. Concerning *bona fide* online transactions, customs will not be involved as the services and goods will be delivered via the Internet. The international sale of goods or services can happen unnoticed by state authorities (Krensel, 2005). It has been recognised that tax evasion can occur when e-commerce businesses in particular mask their identities (Bristol, 2001). Current website name and

registration procedures require nothing more than a credit card. There is no existing process to accurately verify ownership or the physical location of the beneficial owner of the website. In an e-commerce environment, the possibilities of hiding transactions are vast and the possibilities of identifying parties to a transaction are in many cases virtually non-existent (Basu, 2008). Therefore, the potential for tax evasion through e-commerce is very high (Bristol, 2001) and the opportunities for tax evasion seem endless (Basu, 2008). Governments are continuously striving to reduce the problem of tax evasion because, without taxation, the survival of any government is at stake (Jain, 2013).

It was specifically identified in the European Union that problems relating to possible tax evasion and avoidance arise due to differences in the definitions of services and intangible property in member countries that lead to uncertainty about the tax treatment of such supplies provided by overseas businesses. These differences may open up opportunities for tax avoidance and evasion (European Parliament, 1999). It is therefore necessary to establish definitions and rules that are international and applied by all the countries to tax e-commerce.

It is possible that e-commerce will result in an erosion of the consumption tax base (Jones & Basu, 2002). Furthermore, e-commerce also makes it easier for businesses to migrate 'overseas'. There can be legitimate commercial reasons why businesses move to another jurisdiction, but there is also a desire to reduce and avoid tax. This highlights another area that has consequences for tax revenues. Since e-commerce provides such mobility and flexibility, businesses will be tempted to locate in low and nil taxed jurisdictions. Consequently, this represents a source for erosion of tax bases (Bristol, 2001).

#### **4.7. Conclusion**

Challenges experienced by countries that have already started to implement VAT rules on e-commerce transactions were discussed in this chapter. The VAT taxation issues of international transactions are far from being solved and are still a topic of discussion worldwide (Krensel, 2005).

Firstly, the challenge exists that there is a limited physical audit trail to verify the details of a transaction and the only verification that exists is electronic versions of invoices, which can be easily altered. This can lead to the changing of details such as the products or services delivered and the relevant parties of the transaction. This can be done to promote the most tax favourable position for tax parties. It might pose a challenge for the South African taxing authorities to verify the details of the transactions and this could lead to a tax loss for the government.

The next challenge that was discussed was the identification of the relevant tax parties to a transactions and the anonymity of the parties. As the parties can supply false details for the transactions, it could be difficult to verify the details of parties by the South African tax authorities. The anonymity of the Internet also increases the challenge to identify the parties of the transaction. It is important to identify the parties to a transaction in order to determine the relevant tax authorities and the relevant tax legislation that will be applicable.

The relevant tax authority is determined by the principle of permanent establishment. The permanent establishment is difficult to determine, as the use of a website alone cannot be used to identify the permanent establishment. The permanent establishment can possibly be determined where the server is located together with other requirements.

The determination of the permanent establishment of the supplier and the relevant tax parties to a transaction may be important for South Africa in order to avoid double taxation and to apply double tax treaties, if applicable, in order to determine which country can tax the transaction. Established double tax treaties can be helpful to identify the relevant taxing

authority; however, most tax treaties were created for income tax purposes and not VAT purposes. Moreover, it will be difficult to implement the double tax treaties if the permanent establishment cannot be determined by the South African tax authorities, as the tax treaties are based on the relevant countries where the permanent establishment is.

In addition to the above, the challenge experienced with determining the permanent establishment will give rise to possible tax evasion and avoidance and the erosion of the tax base of a country as the servers can be located in tax havens and countries where lower tax rates will be applicable. The Internet may drain governments' tax revenues either by making evasion easier or by encouraging economic activity to shift to lower-tax countries (European Parliament, 1999). This can lead to a decrease in the South African revenue base, which is an important source of income for the government.

As can be seen from the discussion in Chapter 4, there are challenges related to imposing VAT on e-commerce. The challenges identified are relevant to all countries that have already implemented VAT on e-commerce. The systems are not yet perfect and alterations are still made to the systems in many jurisdictions in order to address the challenges. The identification and analysis of the challenges might be helpful for South Africa with the implementation of VAT on e-commerce transactions in order to avoid similar problems.

In the following chapter, the South African VAT system will be discussed. This is done in order to identify the impact of the proposal made by the Minister of Finance will have on the current system and whether the above challenges will also need to be considered with the implementation.



## **Chapter 5     Current South African VAT system and e-commerce transactions**

### **5.1.     Introduction**

A background was obtained in Chapter 3 as to how the European Union and government of New Zealand have implemented VAT on e-commerce. In Chapter 4, the challenges experienced with VAT on e-commerce transactions that were identified by different countries who already implemented VAT on e-commerce transactions were discussed. In this Chapter, the South African VAT system will be analysed to identify weaknesses in the system and to gain an understanding of how e-commerce transactions are treated under the current VAT legislation. This will be done in order to gain an understanding why the proposal was made by the Minister of Finance and a new Tax Bill is due to be implemented in the future.

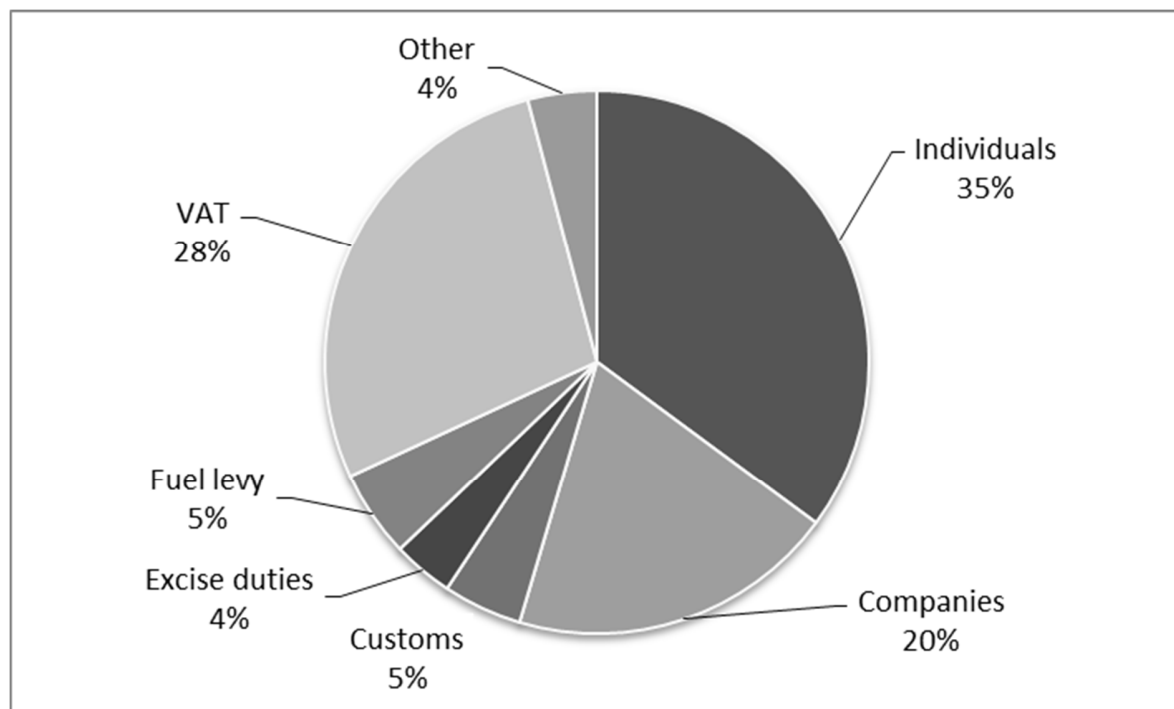
### **5.2.     Background of South African VAT legislation**

In September 1991, South Africa replaced its General Sales Tax (also known as GST) with a consumption-type value added tax (VAT) (Go, Kearney, Robison & Thierfelder, 2005). The South African VAT system resembles the New Zealand model (Sherif, 2012), as the South African VAT Act was based on the principles of the New Zealand GST system. South Africa, however, did not include place of supply rules in its VAT legislation when VAT was introduced in 1991 (Janse van Rensburg, 2011). The difference between VAT and the previous General Sales Tax in South Africa is that the latter is levied against a consumer and not against an intermediate stage entity, whereas with VAT, everyone along the value chain pays VAT. Moreover, VAT is the value that is added to goods and services on consumption (Janse van Rensburg, 2011).

In South Africa, VAT is levied in terms of the Value-Added Tax Act 89 of 1991 (PATC, 2013). The original statutory rate was 10 percent, which was subsequently raised to 14 percent in 1993 (Go & Kearney & Robison & Thierfelder, 2005).

Currently, VAT is a significant contributor to the South African fiscus (National Treasury, 2012). VAT contributed 27.8% to total tax revenue for the 2013/2014 tax year (Lings, 2013).

Figure 5: Breakdown of South African tax revenue 2013/2014



Source: Lings, 2013

As seen from the above graph and information, VAT is an important component for South Africa's revenue base. In the event that businesses exploit the fact that there is no specific legislation governing electronic commerce and virtual world transactions, the South African fiscus could potentially lose a significant portion of its revenue derived from VAT (Johnston & Pienaar, 2013).

The VAT law in South Africa was not written to cater for digital transactions, such as online downloads of movies, music, games or access to content in the cloud (Internet-based storage mechanisms). South African VAT laws were written with a focus on physical goods and in-person services (Jooste, 2013). To date, no amendments have been made to the South African VAT Act, to ensure that it specifically provides for the imposition of VAT on the supply of

digitised products (Carstens, 2012). E-commerce has not affected value-added tax (VAT) laws in the same manner as income-tax laws, but has led to an exponential increase in cross-border transactions in respect of which tax laws need to be adjusted (Bardopoulos, 2013). The present position in South Africa is one of uncertainty as there are no clearly defined rules to tax e-commerce transactions and promises of clarity have been made but not fulfilled for a number of years (Smuts, 2012). Moreover, the South African VAT legislation is unclear and it is not possible to make any definitive statements for the global businesses regarding the importation of e-commerce in South Africa, except to say that they are likely to have a VAT liability in South Africa (Smuts, 2012).

South Africa differs from other VAT jurisdictions, because it has not yet introduced any substantial guidance on electronic commerce or introduced legislative provisions to deal with electronic commerce efficiently. Traditionally, the current South African taxing principles must be applied in determining whether electronically supplied services are subject to VAT in South Africa (Deloitte & Touche, 2010). The question therefore arises whether the VAT Act in its current form in fact provides for the imposition of VAT on the supply of digitised products and whether imposing VAT is consistent with the principles formulated by the OECD (Carstens, 2012).

South Africa recognised the significant risks in respect of the cross-border supply of digital products by foreign multinational enterprises to South African consumers (Badenhorst, 2013); therefore, the proposal was made by the Minister of Finance that foreign suppliers of e-commerce must register for VAT purposes. In an attempt to create certainty and to curtail foreign suppliers of e-commerce from escaping the VAT net in South Africa, it will be implemented based on the Minister of Finance's proposal that all foreign suppliers are obliged to register as VAT vendors and account for output tax in respect of e-commerce supplies made to South African customers (Lessing, Mazansky, Rood, McGurk & Malan, 2013).

Therefore, the current South African VAT legislation and the effect on the imported e-commerce transactions will be discussed and analysed to identify why the Minister of Finance announced that foreign businesses need to register for VAT when supplying e-commerce in South Africa.

### **5.2.1. The South African VAT Act**

Section 7(1)(a) of the South African VAT Act requires a vendor to impose VAT on a supply made if that vendor is carrying on an enterprise and the supply is made in the course or furtherance of that enterprise (De Swart & Oberholzer, 2006). Based on this requirement of the VAT Act, the definition needs to be considered within the context of the imported e-commerce transactions and analysed to obtain an understanding of the current VAT system taxing e-commerce.

### **5.2.2. Enterprise**

An “enterprise” is defined in section 1 of the VAT Act as “any enterprise or activity carried on continuously or regularly by a person in the Republic or partly in the Republic in the course or furtherance of which goods or services are supplied to another person for consideration provided that, a branch or main business permanently situated at premises outside the Republic, is a separate vendor, if it can be separately identified and an independent system of accounting is maintained” (Stelloh & Stack, 2007).

Furthermore, the definition of an enterprise in section 1 of the South African VAT Act and the VAT import and export rules operate together to determine whether or not the consumption of a service is considered to have taken place in South Africa and is consequently subject to South African VAT (De Swart & Oberholzer, 2006). It was identified that while the absence of place of supply rules arguably creates flexibility in determining the jurisdiction of supply, it also creates uncertainty as to whether a non-resident meets the criteria for carrying on an ‘enterprise’ in South Africa (Deloitte & Touche, 2010). It can be identified that the place of supply and enterprise needs to be discussed as well as determining what it specifically entails.

The interpretation when using words such as ‘activity’ or ‘enterprise’ is very wide and will lead to the understanding that most activities (unless specifically excluded) will constitute an ‘enterprise’. An enterprise refers to the kind of activities that are carried out

within a commercial context where goods or services are supplied for a consideration. Typically, this refers to a business or similar venture, conducted in an organised and business-like manner, where an element of risk-taking is involved, and where the aim is to grow or make a profit or to ensure that the organisation's activities are sustainable (SARS, 2013). The definition of an enterprise in section 1 of the VAT Act requires an activity to be conducted continuously or regularly in, or partly in, South Africa (Swart & Oberholzer, 2006). However, the concepts 'continuously' or 'regularly' are not defined in the VAT Act and have not been judicially considered within the context of VAT (Botes, 2011).

Consumption taxes were developed under the premise of the physical presence of a product within a specific taxation jurisdiction (Carstens, 2012). In practice, the fact that a business has a physical presence in South Africa, delivers goods or physically renders services, or concludes agreements in South Africa, whether through an employee, agent or subcontractor, is normally indicative that it carries on an activity in South Africa (Botes, 2011). However, the Internet has no physical location. Users of the Internet have no control and in general no knowledge of the path travelled by the information they seek or publish (Department of the Treasury Office of Tax Policy, 1996). With e-commerce, such a physical presence is no longer necessary (Carstens, 2012). Therefore, there is no physical presence in South Africa for e-commerce and the services are not rendered physically in South Africa.

Whether or not 'premises' are the equivalent of a 'permanent establishment' is not clear, but the need for an independent system of accounting is one determinant. Whether a server, together with its administration, would be considered a vendor, is also questionable (Stelloh & Stack, 2007). From a tax standpoint, websites and servers through which these transactions are made do not constitute a taxable presence in another country, since a website alone is not a fixed place of business (IBLS Editorial Department, s.a.). For example, if assuming that a supplier is not established in South Africa, this leads to the understanding that only enterprises within the jurisdiction of

South Africa are governed by the VAT legislation of South Africa, whereby foreign enterprises will not fall within the South African VAT net (Budlender, 2003).

The lack of clarity regarding the question of when a foreign supplier is regarded as carrying on an enterprise in South Africa is a major deficiency in the current South African VAT system, specifically with regard to the imposition of VAT on the supply of digitised products (De Swart & Oberholzer, 2006). In the absence of clarity as to whether a foreign supplier of digitised products is carrying on an enterprise in South Africa, the supplier will not be able to make the correct tax decision (De Swart & Oberholzer, 2006).

### **5.2.3. Destination vs. place of supply**

Tax jurisdictions apply similar principles and concepts with respect to VAT; however, there are differences that hinder the effective, fair and equitable application of VAT globally. An example is the application of ‘place of supply rules’ to provide clarity on where a product is considered to have been supplied and, therefore, subject to VAT (Bardopoulos, 2013).

The South African VAT system is based on the destination or consumption of the goods or services supplied (Janse van Rensburg, 2011); therefore, if consumed in South Africa, regardless of where the goods are produced or services are supplied (SARS, 2007), it will be taxed in South Africa. This implies that VAT is only payable on the consumption of goods and services, which takes place in South Africa, and on the importation of goods and services into South Africa. The initial place where these goods and services are supplied is not taken into consideration (Janse van Rensburg, 2011). Exports that are not consumed in the country are therefore free of tax, and imports that are consumed in the country are taxed when imported (SARS, 2007).

A problem arises where intangible services are traded across borders and delivered electronically (e.g., consultancy, broadcasting, telecommunication services) (Steyn, 2010). An unusual feature of the South African VAT system is that it does not, unlike

other VAT jurisdictions, use specific 'place of supply' rules to determine whether a supply is subject to VAT in South Africa (Carstens, 2012). Without clear place of supply rules, the South African legislation is open to interpretation (Steyn, 2010).

It is not always clear where the services are utilised or consumed and the absence of 'place of supply' rules from the VAT Act enhances this problem (Badenhorst, 2013). Therefore, it makes it difficult to determine a particular foreign entity's obligation to register in South Africa (Deloitte & Touche, 2010). At the stage of implementation of the VAT system, the system did not have 'place of supply' rules in place and they still have not been introduced fully into the system of taxation (Soverall, 2012).

Based on the consumption-based VAT system of South Africa, services are therefore taxed in South Africa if the consumer is located in South Africa (De Swart & Oberholzer, 2006). It might be true that the VAT Act implies that VAT should be levied at the place of consumption (Steyn, 2010). However, although VAT is generally a consumption tax, consumption (or the use and enjoyment) of the supply does not form the basis of determining whether the supply would be subject to VAT (SAICA, 2012). The concept of 'place of consumption' is difficult to define without proper guidelines in the South African legislation (Steyn, 2010). In South Africa, the place of supply is connected to the definition of 'enterprise' in the VAT Act as discussed in the previous point. It follows that VAT is levied on supplies made by a person who conducts an enterprise continuously or regularly in South Africa, or partly in South Africa (Steyn, 2010). The basis of determining whether a supply is subject to VAT is whether it is being supplied by a person supplying goods and/or services, inside or partly inside South Africa, on a continuous and regular basis, for a consideration.

Furthermore, there are no specific use and enjoyment rules applicable in terms of South African VAT. This means that merely because a service is not consumed or utilised in South Africa, it does not mean that it is not included into the South African VAT net (SAICA, 2012). Due to the lack of specific place of supply rules, it is often difficult to determine whether a non-resident business, which is not established in South Africa, will

be regarded as carrying on a VAT enterprise in South Africa. From the definition of an enterprise, it follows that where a server has been placed within the jurisdiction, an enterprise is conducted in South Africa and such company would be exposed to local VAT, even though the company is incorporated outside South Africa (Michalson & van Zyl, 2009).

Taking into account the above principle, in practice, the view has always been taken that if the supplier has no presence or representation in South Africa and the digital product is supplied through a server located outside South Africa, the non-resident business will not be liable for VAT registration (PWC, 2013). However, the determination of the location of the server can create difficulties. It is complicated to locate the jurisdiction in which these services are being consumed. Where an order is placed via the Internet, for instance, it may be difficult to identify or locate the parties to the transaction, especially if the customer is a private consumer. The domain name in the e-mail address or top-level domain name of the website of a contracting party does not provide sufficient proof of the supplier's location, purely because domain names are no longer territorial (Steyn, 2010).

Since the supply of the service is from a foreign source, it might arguably attract VAT in the country from which the services are rendered and not where it is consumed (Janse van Rensburg, 2012). However, based on the current legislation of South Africa, imports in South Africa will be liable for VAT implications. The problem with the current treatment of imports is that it can result in double taxation. Where the service is rendered from a country that has place of supply rules dissimilar to South Africa, double taxation could occur. The recipient of the service can be liable to pay VAT in both countries (Janse van Rensburg, 2012). South Africa has double taxation agreements, which aim to prevent or mitigate the effect of taxing transactions in both of the signatory countries and to provide mutual assistance in administering the collection of taxes (Stelloh & Stack, 2007). Although South Africa has various signed double tax agreements in place, they mainly cater for double taxation of income tax and none of them cater for VAT (Janse van Rensburg, 2012).



It is evident that the existing rules may no longer be sufficient, or may have to be revisited because of identification and compliance problems (Van der Merwe, 2003). Evidently, the huge increase in the advent of electronic commerce transactions makes South African VAT legislation outdated and consequently the taxable nature of transactions difficult to determine (Deloitte & Touche, 2010).

### **5.3. Implications for electronic transactions under the current VAT system**

An understanding was obtained of the current VAT system in South Africa in section 5.2. In the following points, it will be considered how the implementation of VAT on e-commerce transactions will be affected under the current VAT system. E-commerce customers are unaware of their obligation under the current VAT legislation to account for VAT at the standard rate of 14% in respect of their purchases of e-products from foreign suppliers. This is known as the reverse VAT charge (Martineau, McFadden & Naidoo, 2013).

#### **5.3.1. Reverse charge mechanism:**

Section 7(2) of the VAT Act states that “the tax payable in terms of paragraph (b) of that subsection shall be paid by the person referred to in that paragraph” (VAT Act, 1991). This creates the situation that it is not the vendor who is responsible for the collection of the tax, but the person who imported the goods or services into South Africa. This is known as the reverse charge mechanism (Budlender, 2003).

The VAT Act currently states that a resident has to account for VAT on services acquired from a supplier who is not a resident of South Africa, or who carries on a business outside South Africa to the extent that the services are not used in the course of making taxable supplies (BDO, 2013). Because of the lack of ‘place of supply rules’ in the South African legislation, South Africa applies the ‘reverse charge mechanism’ with respect to imported services acquired from a non-resident business, consumed in South Africa and not bought for purposes of making taxable supplies subject to VAT. In terms of this

mechanism, the South African consumer must account for the VAT on such a purchase (Bardopoulos, 2013).

This means that when consumers download software, music, movies and so forth from foreign suppliers, they must account for the VAT on the supplied products (Bardopoulos, 2013). In South Africa, the reverse charge mechanism is applied on both B2B and B2C transactions, whereby the South African resident (whether or not VAT registered) is required to account for the VAT on imported services, but the reverse charge applies only to the extent the supplier is not carrying on an enterprise in South Africa and is required to register for VAT in South Africa (Deloitte & Touche, 2010). The supplier is not responsible for the VAT because the supplier is not in the geographic region of the Republic, and in terms of the South African legislation is not governed by the Act, nor is the supplier within its jurisdiction (Budlender, 2003).

The South African customer is liable for the payment of VAT on imported services under the reverse charge rule, to the extent that the digital products are acquired for non-taxable purposes and if the invoice value exceeds R100.00. If the customer is a VAT vendor, the VAT on imported services must be accounted for on the normal VAT return form, while a customer who is not a VAT vendor must, within 30 days, declare and pay the VAT on imported services to SARS.

The broadened scope and obligation placed on non-registered consumers to account for output tax on imported services are generally not enforced, as the administrative costs are both unrealistic and impractical (Bardopoulos, 2013). The purchase of an online service is very simple at present for the customer, but very difficult to control and monitor by the government (Stelloh & Stack, 2007). This system relies on the honesty of the consumer of the products and is very difficult to enforce (Johnston & Pienaar, 2013). This has the effect that South African consumers often buy imported digital goods or services without paying VAT (PWC, 2013).

While no statistical studies have been found on the ensuing loss of revenue, it may prove to be a large loss for South Africa and for other jurisdictions globally. It is evident that the South African government is aware of this problem, as shown by the Minister of Finance's proposal in his 2013-14 Budget Speech to require non-resident e-commerce businesses that supply goods or services in South Africa to register for VAT (Bardopoulos, 2013).

However, South Africa already has specific registration rules set out in the current VAT legislation. It is important to consider how this will be affected by the new proposal of the Minister of Finance regarding VAT registration for foreign suppliers of e-commerce.

### **5.3.2. Registration implications for non-residents**

The current VAT system provides for compulsory and voluntary registration as a VAT vendor. Every person who carries on any enterprise must be registered if the total value of his/her taxable supplies made in the course of carrying on all enterprises has exceeded R1 million in the preceding 12 months or if there are reasonable grounds for believing that he/she will exceed that limit in the next 12-month period (Botes, 2011). However, foreign suppliers of e-commerce having no physical presence in South Africa are not obliged to register as VAT vendors in terms of the current VAT legislation (Lessing, Mazansky, Rood, McGurk & Malan, 2013). Furthermore, it is difficult to determine whether the foreign supplier carries on an enterprise as discussed earlier.

For e-commerce transactions, the current VAT Act exempts imported services into South Africa with an invoice value of less than R100.00. For supplies exceeding R100.00, it is difficult to collect VAT from individual consumers as discussed in section 5.3.1, thereby placing the foreign enterprise in a competitive advantage compared to local suppliers that have to charge VAT (Badenhorst, 2013).

## **5.4. Conclusion**

In Chapter 5, an understanding of the current South African VAT legislation was obtained. The weaknesses relating to e-commerce in the current VAT legislation were identified and discussed as well as the VAT implications for imported e-commerce transactions under the current VAT legislation.

It was identified that South Africa lacks place of supply rules, which often creates uncertainty about whether a product is subject to VAT and when a foreign supplier is considered to be carrying on an enterprise for VAT purposes in South Africa (Bardopoulos, 2013). If place of supply rules were specifically incorporated in South African VAT legislation, the imported services would be taxed in the country of supply and therefore would avoid any double taxation of the imported services (Janse van Rensburg, 2012). However it should be considered whether place of supply rules will be the most favourable for the South African government, as they will not then receive VAT on imported services. It was suggested that governments should align their VAT principles, descriptively defined as the harmonisation of VAT, which will allow them to collect VAT more efficiently and reduce double taxation. It will also create a more equitable playing field for suppliers by ensuring that foreign suppliers are not granted an economic advantage over local ones (Bardopoulos, 2013).

Under the current VAT legislation, South Africans are liable for VAT on imported e-commerce transactions. Digital products, which are not intended to be used for the making of taxable supplies in South Africa, acquired from a foreign supplier, who is not a VAT-registered supplier in South Africa, will be subject to VAT in South Africa under the current VAT legislation. The recipient of the service or digital product is obliged to account for the VAT on the transaction by paying the VAT to SARS within 30 days of receiving the invoice from the supplier or paying for the product or service. SARS is therefore reliant on the honesty of the taxpayer to declare and remit the VAT (Naicker, 2010).

## **Chapter 6 Conclusion**

### **6.1. Background of the research**

This research identified that e-commerce is growing annually and has a significant impact on the economy of South Africa. When the Minister of Finance announced that VAT registration would become compulsory for foreign suppliers importing e-commerce transactions into South Africa, there were many speculations regarding the implication it will have for South Africa.

The main objectives of this research, as set out in Chapter 1, are to determine whether the current VAT structure and VAT Act in South Africa will be able to support the proposal made by the Minister of Finance and what possible challenges should be considered regarding VAT on e-commerce transactions that were already identified by other countries.

### **6.2. The definition of e-commerce**

In Chapter 2, the term electronic commerce or e-commerce was analysed in order to obtain a broad understanding of what e-commerce means. Different models that have been created to define e-commerce transactions were considered and compared to each other. Chan and Swatman (1999) identified that it was evident that it is difficult to define e-commerce transactions in one definition or model, as there are so many different components to it and all the models included different e-commerce types, activities and capabilities. E-commerce is a broad subject and includes different elements that need to be identified and considered; however, as it is such a broad subject, it is difficult to take all the elements together in one model. A few key characteristics could, however, be identified that were similar in the models, for example, there is a similarity in the type of e-commerce identified for the structuring of each model, such as wireless Internet, electronic funds transfer (EFT) and the World Wide Web. Furthermore, another similarity identified is that these models take the same technical infrastructure and transactions into account when forming the individual models.

Just as there are different models relating to e-commerce transactions and the elements of e-commerce transactions, there are different definitions for e-commerce transactions. Countries have defined e-commerce transactions differently throughout the years for their own tax and business purposes. The definitions by the OECD, the European Union and New Zealand were compared to the definition South Africa has adopted for e-commerce transactions.

The definitions identified in the research can be summarised as follows:

Table 4: Summary of definitions from different countries

<b>Country, union or organisation</b>	<b>Definition</b>
OECD (2002)	“An electronic transaction is the sale or purchase of goods or services, whether between businesses, households, individuals, governments, and other public or private organisations, conducted over computer-mediated networks. The goods and services are ordered over those networks, but the payment and the ultimate delivery of the good or service may be conducted on or off-line”
European Commission (2013)	“Examples of services covered by the Directive include online information services (such as online newspapers), online selling of products and services (books, financial services and travel services), online advertising, professional services (lawyers, doctors, estate agents), entertainment services and basic intermediary services (access to the Internet and transmission and hosting of information)”
New Zealand Parliament (2001)	“E-commerce” refers to the buying and selling of goods and services via electronic networks, principally the Internet. Its definition is sometimes expanded to include other aspects of e-business.

Department of Communications Republic of South Africa (2000)	“The use of electronic networks to exchange information, products, services and payments for commercial and communication purposes between individuals (consumers) and businesses, between businesses themselves, between individuals themselves, within government or between the public and government and, last, between business and government”
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Although many definitions for e-commerce transactions exist, the research identified that the fundamental characteristic of e-commerce is similar. Chan and Swatman (1999) further identified that the similarities in the fundamental characteristic in the definitions make it clear that e-commerce involves the use of electronic and telecommunications technologies to improve business processes.

By analysing and comparing the different definitions, Chan and Swatman (1999) identified that electronic commerce transactions essentially mean the undertaking of normal commercial, government and personal activities by means of electronic and telecommunications networks, and includes a wide variety of activities involving the exchange of information, data or value-based exchanges between two or more parties. By comparing the definitions, it was established that e-commerce transactions, unlike traditional commercial transactions, are mainly conducted via electronic networks.

It was furthermore identified that e-commerce transactions could be divided into direct and indirect e-commerce. Direct e-commerce relates to intangible goods ordered and delivered via the Internet, whereas indirect e-commerce transactions relate to tangible goods ordered via the Internet. The focus of this research was on direct e-commerce, where all transactions are conducted and delivered electronically.

To be able to address the objectives of the research, the understanding regarding whether direct e-commerce, as identified, would be classified as goods or services for VAT purposes should be enhanced, because there are different rules that apply to goods and services under

the VAT Act in South Africa and other countries. Based on the definitions and discussions, it was concluded that direct e-commerce transactions, which relate to intangible goods, would be defined as services. This was in line with the policy implemented in the European Union. In addition, the OECD proposed to treat digitised products as services when the original framework for taxation on e-commerce was developed.

### **6.3. VAT on e-commerce transactions in the European Union and New Zealand**

As e-commerce was defined and analysed to ensure the objectives will be met, Chapter 3 compared the different VAT frameworks that exist for the defined e-commerce transactions in different countries.

The OECD framework and recommendations regarding the treatment of VAT on e-commerce transactions were considered and compared to the current VAT system implemented for e-commerce transactions in the European Union and New Zealand. Similarities were noted when the systems and frameworks were compared. Both New Zealand and the European Union have implemented the reverse charge mechanism on business-to-business transactions, which appears to be efficient. Reverse charge shifted the liability for tax from the foreign supplier of the imported service to the registered resident recipient, which simplified the VAT collection process. Furthermore, both have implemented the rule that foreign companies supplying e-commerce to residents should register, which means that the supplier should register in New Zealand as a VAT vendor or, when supplying to a resident of the European Union, in one of the member states of choice. This is in line with the proposal made by the Minister of Finance in the 2013 Budget Speech.

In addition, the research revealed that there are still difficulties with the VAT rules with regard to the business-to-consumer transaction in the European Union, as there are constantly amendments in the rules throughout the years and new rules are to be implemented in 2015. The difficulties that are experienced when implementing VAT on e-commerce transactions in the European Union, New Zealand and other countries were discussed in detail in Chapter 4.



The difficulties are highlighted as considerations for when South Africa implements VAT on e-commerce. The taxation issues relating to VAT on international transactions are far from being resolved and are still a topic of discussion worldwide.

#### **6.4. Challenges identified regarding VAT on e-commerce transactions**

Firstly, it was identified that the challenge exists that there are limited physical audit trails to verify the details of a transaction and the only verification that exists is electronic versions of invoices, which can be easily altered. This can lead to the changing of details such as the products or services delivered and the relevant parties of the transaction in order to promote the most tax favourable position for tax parties. It might pose a challenge for the South African taxing authorities to verify the details of the transactions and this could lead to a tax loss for the government.

The next challenge that was identified was the identification of the relevant tax parties to a transactions and the anonymity of the parties. As the parties can supply false details for the transactions, it could be difficult to verify the details of parties by the South African tax authorities. The anonymity of the electronic and Internet transactions furthermore increases the challenge to identify the parties of the transaction. It is important to identify the parties to a transaction in order to determine the relevant tax authorities and tax legislation that will be applicable.

The relevant tax authority is determined by the principle of permanent establishment. The permanent establishment is difficult to determine, as the use of a website cannot be used to identify the permanent establishment. The permanent establishment can possibly be determined where the server is located. The determination of the permanent establishment of the supplier and the relevant tax parties to a transaction may be important for South Africa in order to avoid double taxation and to apply double tax treaties, if applicable, in order to determine which country can tax the transaction. In addition, the difficulties experienced in determining the permanent establishment will give rise to possible tax evasion and avoidance and the erosion of the tax base of a country, as the servers can be located in the tax haven and

countries where lower tax rates will be applicable. It was identified in the study that the Internet might drain governments' tax revenues either by making evasion easier or by encouraging economic activity to shift to lower-tax countries. This can lead to a decrease in the South African revenue base, which is an important source of income for the government.

Established double tax treaties can be helpful to identify the relevant taxing authority; however, most tax treaties were created for income tax purposes and not for VAT purposes. Therefore, it will be difficult to implement the double tax treaties if the permanent establishment cannot be determined by the South African tax authorities, as the tax treaties are based on the relevant countries where the permanent establishment is.

The challenges identified are relevant to all countries that have already implemented VAT on e-commerce. There currently is not yet a single perfected system and changes will be implemented in the future. The identification and analysis of the challenges might be helpful for South Africa with the implementation of VAT on e-commerce transactions in order to avoid similar problems. It was concluded that there is still much that can be learned from other countries' implementation of VAT on e-commerce transactions in their VAT legislation and VAT structure; however' there is also room for improvement.

## **6.5. South Africa's current VAT system**

In Chapter 5, an understanding of the current South African VAT legislation was obtained. The weaknesses relating to e-commerce in the current VAT legislation were identified and discussed as well as the VAT implications for imported e-commerce transactions.

The research confirmed Bardopoulos's (2013) statement that South Africa lacks place of supply rules, which often creates uncertainty about whether a product is subject to VAT and when a foreign supplier is considered to be carrying on an enterprise for VAT purposes in South Africa. It can be noted that if place of supply rules were specifically incorporated in South African VAT legislation, the imported services would be taxed in the country of supply and therefore avoid any double taxation of the imported services.

Under the current VAT legislation, South Africans are liable for VAT on imported e-commerce transactions. Digital products, which are not intended to be used for the making of taxable supplies in South Africa, acquired from a foreign supplier, who is not a VAT-registered supplier in South Africa, will be subject to VAT in South Africa under the current VAT legislation. The recipient of the service or digital product is obliged to account for the VAT on the transaction by paying the VAT to SARS within 30 days of receiving the invoice from the supplier or paying for the product or service. SARS is therefore dependant on the honesty of the taxpayer to declare VAT on all e-commerce transactions.

It was concluded that the current South African VAT system is not sufficient for the implementation of VAT on e-commerce transactions. South Africa might need to take into account the problems that are experienced and adjustments implemented by the other countries currently and how the current VAT legislation is lacking before implementing VAT on e-commerce transactions.

#### **6.6. Limitations experienced during the research**

During the research, a number of important limitations were experienced regarding the international and the national VAT systems relating to e-commerce transactions.

Limitations experienced on the international VAT system included the lack of a single definition and model for e-commerce transactions. It is difficult to define e-commerce transactions as there are many aspects to the transaction and there is no constant definition or model considering the same factors. Furthermore, the study was limited by the other countries' VAT systems that are still undergoing changes to perfect the system for e-commerce transactions. This leads to no perfect VAT system that can be used as a benchmark for the implementation of VAT on e-commerce transactions. During the research, it was noted that South Africa lacks place of supply rules resulting in South Africa being one of few countries that have yet not adjusted their VAT systems. This leads to different VAT systems not working coherently together with different rules applicable in the different

countries. This leads to inconsistencies in the VAT treatment of e-commerce transactions and the harmonisation of the VAT systems worldwide.

An issue that was not addressed in this study was the new Tax Bill released for comments by the National Treasury, October 2013, proposing changes to the VAT Act to require the VAT registration of foreign suppliers of e-commerce transactions imported into South Africa. The most current legislation and announcements up until the finalisation of the research were taken into consideration.

## **6.7. Conclusion and recommendation**

This research identified that the current South African VAT legislation has weaknesses that need to be considered when the Minister of Finance's proposal is implemented. Furthermore, the current South African VAT structure is reliant on the honesty of the taxpayer to declare all imported e-commerce transactions that were incurred. This is difficult to control for the South African tax authority, SARS, and may lead to tax evasion and the erosion of the tax base. Unless South Africa implements new rules regarding VAT on e-commerce transactions, the current VAT legislation will not be able to sustain the proposal made by the Minister of Finance.

More research can be done in future to determine the impact on the South African economy and feasibility of the new rules in practice with the release of the new Tax Bill regarding the VAT registration for suppliers of e-commerce transaction. A few factors that can be noted on the new tax bill will be highlighted below.

Suppliers of electronic services will face various compliance challenges, including the system changes to cater for these changes; however, this will only be a once-off cost, but can be costly. The new legislation will require that the systems of foreign companies need to be changed to effect price adjustments resulting for the inclusion of the 14% VAT in the prices and invoices and in order to identify SA resident customers and payments made through SA bank accounts (Schneider, 2013).

VAT registration will be a once-off cost and depending on whether SARS streamlines the VAT registration process, it can be expensive and time-consuming exercise. VAT filing costs will be a continuous cost and the frequency of filing will depend on whether SARS will create a special category or period within which these suppliers would need to file. Furthermore, for all foreign electronic service providers, appointing a VAT representative in South Africa who needs to be natural person would be a low but a continuous cost (Schneider, 2013).

It is therefore evident from the research that it is necessary to implement the new Tax Bill, however it will not without enforcement challenges. The implementation of the new Tax Bill is a move in the right direction to create a better South African VAT system in line with international VAT systems.

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