

**THE PRINCIPLES OF SOURCE AND RESIDENCE TAXATION OF
ELECTRONIC COMMERCE TRANSACTIONS IN SOUTH AFRICA**

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English summary

This study will present the traditional legal aspects for fiscal jurisdiction of direct taxation being the principles of source and residence income taxation as they have developed internationally and in South Africa. The focus will be on these principles as they manifest in the form of electronic commerce transactions on the Internet, a visible form of the global electronic revolution. Such examination will be undertaken in this study in order to determine what the most appropriate method would be for the South African Revenue Service to levy income tax for electronic commerce transactions, namely, source-based or residence-based income taxation.

Key words used in this study

1. Taxation
2. Electronic commerce taxation
3. Source-based income taxation
4. Residence-based income taxation
5. Permanent establishment
6. Place of effective management

Afrikaanse opsomming

Die studie sal 'n uiteensetting bied van die tradisionele aspekte van fiskale jurisduksie, naamlik bron en inwonerbaseerde belasting soos van toepassing op direkte belasting. Dit sal geskied aan die hand van die ontwikkeling wat hierdie aspekte getoon het beide internasionaal en in Suid-Afrika. Gevolglik sal gefokus word op hierdie beginsels in die lig van elektroniese handelstransaksies deur middel van die Internet, wat as 'n duidelike globale revolusie gesien kan word. Hierdie ondersoek sal plaasvind om te bepaal wat die mees gepaste metode is wat aangewend kan word deur die Suid-Afrikaanse Inkomstebelastingsdiens om inkomste belasting te hef ten opsigte van van elektroniese transaksies, naamlik bron of inwonerbaseerde inkomstebelasting.

Sleutel woorde gebruik in hierdie studie

1. Belasting
2. Elektroniese handelstransaksie belasting
3. Brongebaseerde inkomstebelasting
4. Inwonerbaseerde inkomstebelasting
5. Permanente saak
6. Plek van effektiewe bestuur

Render therefore to all their due: taxes to whom taxes *are due*, customs to whom customs, fear to whom fear, honour to whom honour.

Romans 13:7 (NKJ)

1 Prolegomena

1.1 Introduction

In 1877 the eminent German geographer, Ferdinand von Richthofen (1833-1905), first used the term '*Seidenstrassen*', or 'silk roads'.¹ These silk roads (also known as the 'silk routes') consisted of an interconnected series of ancient trade routes through various regions of the Asian continent.² The roads became the avenue of transportation between the East and West during the Han Dynasty of ancient China (202 BC – 220 AD).³ Their development was the phenomenon that revolutionarised the contemporary form of international trade, all due to one major commodity; that commodity was silk. The silk routes provided communities with the means to trade certain products, such as jewels, for silk and, in turn, trade the silk for the commodities that they required; providing each community with new commodities from the far corners of the interconnected trade routes.⁴

As a natural development, the rise in international trade that the silk roads brought saw money replacing bartering. At first coins were used. These were later replaced by paper money as merchants and traders grew to accept credit notes that had an 'international' acceptability and naturally found them easier to transport. The silk roads transcended geographical boundaries and revolutionarised the means by which people traded with one another. The strides taken by the traders and merchants on those interconnected trade routes became the 'blue print' for how international trade was to be conducted in modern times. Two millennia later, it is the 'electronic revolution' that is to affect international trade in the manner of the silk roads of China.

¹ Elisseeff "Approaches Old and New to the Silk Roads" 1-3.

² Elisseeff "Approaches Old and New to the Silk Roads" 1-3.

³ Togan "Inner Asian Muslim Merchants at the Closure of the Silk Routes in the Seventeenth Century" 248.

⁴ Elisseeff "Approaches Old and New to the Silk Roads" 3.

The 'electronic revolution' has caused a globalisation of international trade, catalysed by the development of the 'Internet'. With an estimated 225% growth in usage from 2000 until 2007, the Internet is currently being utilised by 17.8% of the world's population. Africa accounts for 3.6% of world Internet users of which South Africa accounts for 15.2% of total Internet users in Africa. South Africa itself has had an estimated 112.5% growth in Internet usage between 2000 and 2007, with an estimated 10.3% Internet usage population penetration figure. In South Africa, therefore, there are currently an estimated 5,100,000 million Internet users for 2007, making the Internet a reality for millions of South Africans on a daily basis.⁵

Globally, as in South Africa, usage of the Internet has penetrated the average population with most usage found in North America, Australia (including Oceania) and Europe.⁶ It cannot therefore be denied that the Internet has sparked an electronic revolution that "will once again transform our lives".⁷

Much as the silk roads were the means for the transformation of trade between the East and the West over two millennia ago, so is the Internet the means for this transformation with the modern commodity equivalent of silk being information.⁸

1.2 Background to the research

Often also referred to as the 'information superhighway' or 'cyberspace', the Internet now reaches around the world between "an ever increasing number of participants, corporate and individual, known and unknown".⁹ The Internet, at its most basic form, can be divided into two components; the physical structure that

⁵ Internet World Stats 2007 <http://www.internetworldstats.com/stats1.htm>

⁶ Internet World Stats 2007 <http://www.internetworldstats.com/stats.htm>

⁷ Clinton 1997 <http://www.clintonfoundation.org/legacy/070197-remarks-by-president-on-framework-for-global-electronic-commerce.htm>

⁸ Muscovitch 2005 http://www.firstmonday.org/issues/issue2_10/muscovitch/

⁹ Commission 1997 <ftp://ftp.cordis.europa.eu/pub/esprit/docs/ecomcom.pdf>

creates the conduit through which the Internet exists, and the content that makes up the information that a user of the Internet can see.¹⁰ The physical structure (or the 'backbone') connects computers with cables, routers, switches and satellites world-wide allowing them to "communicate with and transfer information to each other".¹¹ Juxtaposed to this, the content of the Internet (or the information) is transferred between computers on the Transmission Control Protocol/Internet Protocol.¹² This forms an international software platform on which computers can "send and receive commands from each other".¹³ Both components have an inherent nature giving characteristics to each other, thus:

...[t]he backbone exists in three-dimensional space, the first frontier of human existence. The contents exist in the cyber world of digit-dimensions that may be called the second frontier of human existence, and is regarded as a parallel world.¹⁴

¹⁰ Alberts "Internet regulation" 393.

¹¹ Alberts "Internet regulation" 394.

¹² Buys and Rothman "The Internet: an Overview" 11 explains what Transmission Control Protocol/Internet Protocol ("TCP/IP") is, as: "...a collection of packet-switched computer networks, glued together by a set of software protocols called TCP/IP (Transmission Control Protocol/Internet Protocol). These protocols allow networks and the computers connected to them to communicate and share information. TCP/IP create what is called a packet-switched network, a kind of network intended to minimise the chance of losing any data sent over networks. First, TCP breaks down every piece of data into small chunks called packets, each wrapped in an electronic envelope with Web addresses for both the sender and the recipient. The IP protocol then figures out how the packets are supposed to get from the sender to the recipient passing through a series of routers, like regular mail passes through several post offices on its way to a remote location. Each router examines the destination address of the packets it receives and then passes them on to a router as they make their way to the final destination. If an e-mail message was broken up into ten packets by TCP, then each of those may have travelled a completely different route, but the recipient will never know it because as the packets arrive, TCP takes over again, identifying each packet and checking to see if it is intact. Once all the packets have arrived, TCP reassembles them into the original data". Further, Alhadeff and Cohen "Functionality of Value-added Network Service Providers and their Liability" 232 defines the function of TCP/IP by stating: "...a common language, or protocol, [which] is needed to ensure that the interconnected network of computers communicate with each other clearly".

¹³ Alberts "Internet regulation" 393.

¹⁴ Alberts "Internet regulation" 393.

It is the nature of the backbone,¹⁵ which is the physical component of the Internet, and the nature of the content, which is the information available through the Internet regardless of its location, that make the fixing of a 'traditional fiscal jurisdiction' near impossible. The near impossibility of fixing a 'traditional fiscal jurisdiction' results from the integration of both the physical component and the information component which allows for electronic commerce transactions to be conducted "without having any regard to national or geographical borders".¹⁶ Vendors who utilise the Internet do so with customers who could be "located anywhere in the world, and their customers will be ignorant of, or indifferent to, their location".¹⁷ The Internet can therefore be described as an "emerging market"¹⁸ that has "signalled the beginning of a new era in taxation".¹⁹ This 'new era in taxation' will challenge many of the fundamental tax concepts used globally, including how taxation is collected. It can therefore be said that "old and new established theories and principles of taxation have to be revalued in light of these changes".²⁰

The exponential growth of electronic commerce has forced governments to consider its susceptibility to taxation. The major consideration being that electronic commerce may provide "a potentially new and promising tax base".²¹ Failure to lay the ground work for the taxation of the Internet will result in the fear that electronic commerce will provide opportunities for the misuse of this new tax

¹⁵ Alberts describes the backbone as the: "...hardware that forms the physical building blocks of the Internet [which] must be installed somewhere in the physical or three-dimensional world. This means that the South African section of the Internet's hardware can be found somewhere in South Africa's territorial space. In essence, the backbone currently consists of the following: various computers with modems and servers across South Africa and in other states across the globe; physical telephone cables (copper or fibre-optic) in South Africa, in international waters, and in other states that connect each on-line computer in the world with the other (with the necessary routers and switches); terrestrial transmitters that send and receive messages from one computer to the other within one state; [and] satellites that distribute messages from one computer to the other across the globe". Alberts "Internet regulation" 394.

¹⁶ Du Plessis "Taxation of E-commerce" 297.

¹⁷ Du Plessis "Taxation of E-commerce" 297..

¹⁸ Commission 1997 <ftp://ftp.cordis.europa.eu/pub/esprit/docs/ecomcom.pdf>

¹⁹ Du Plessis and Viljoen "Taxation of E-commerce: Income Tax" 230.

²⁰ Lodin 2001 *Bulletin for International Fiscal Documentation* 02.

²¹ Bird 2005 *Bulletin for International Fiscal Documentation* 138.

base by providing new means to avoid a fiscal jurisdiction for taxation purposes.²²

The South African Revenue Services ('SARS') noted in 1999 that the implications for "traditional concepts of source to connect an item of income with a specific geographical location"²³ are often difficult, if not impossible, in the world of cyberspace.²⁴ Connecting the source of an income to a specific geographical location for taxation purposes has ramifications that go to the very nature of the Internet. And, it is the very nature of the Internet to be a borderless, intangible environment in which a 'virtual business' would potentially not need to maintain a physical presence in the traditional market territory and, by extension, a fiscal jurisdiction for taxation.

Taxation of fiscal jurisdictions in the traditional market territory relies on one of two principles (or a hybrid of both such as in the case of South Africa) the principle of source or the principle of residence based taxation.²⁵ Using the source based principle of taxation, persons, either natural or juridical, are taxed on income that originates within the territorial or geographical confines of a particular fiscal jurisdiction, regardless of the taxpayer's own country of residence. Using the residence based principle of taxation residents, as defined by the legislation of each particular fiscal jurisdiction, are taxed on their worldwide income, regardless of whether or not that income is derived from a source outside the fiscal jurisdiction. The principles of source and residence based taxation are therefore two of the main principles that provide the connecting factor, or *nexus*, of taxation to a particular fiscal jurisdiction.

²² Oguttu and Van der Merwe 2005 *SA Mercantile Law Journal* 305.

²³ Davis 2002 *Acta Juridica* 168.

²⁴ Davis 2002 *Acta Juridica* 168.

²⁵ Van der Bruggen states that: "...almost every country applies both criteria at the same time. Residents are taxable on their worldwide income, while income derived from that country is taxable in that country as well, even if earned by a non-resident". See Van der Bruggen 2000 http://www.journal.au.edu/abac_journal/may00/ecomtax_2.doc

Regardless of whether the principle of source or residence is used for a fiscal jurisdiction's justification to levy tax on income, both these principles were developed within a 'bricks and mortar' reality. Such a 'bricks and mortar' reality is familiar with connections to the territorial or geographical confines of fiscal jurisdictions. For the fiscal jurisdiction of South Africa, the South African Revenue Service's ability to levy tax was originally restricted to income sourced within South Africa's own fiscal jurisdiction. It was the Katz Commission that advised in its fifth interim report that active income should continue to be taxed by the principle of source based taxation and that passive income should be taxed by the principle of residence based taxation.²⁶ Subsequent to the Katz Commission, South Africa adopted a residence based system of taxation for years of assessment commencing on, or after, 1 January 2001.²⁷ The adoption of the residence based system in South Africa affected all residents in that all the receipts and accruals of residents became subject to taxation in South Africa, regardless of their source. The adoption of the residence based system did not, however, change the taxation of receipts and accruals of non-residents where those receipts and accruals were derived from sources within, or that were deemed to be within, South Africa. The adoption of both these principles formed a hybrid system of taxation for the determination of liability for taxation within South Africa's fiscal jurisdiction.

1.3 The research object

A great deal of attention has been focused in South Africa, and internationally, on the taxation of income resulting from electronic commerce. Great debate has raged over whether the traditional principles of source and residence could confidently cater for the taxation of transactions concluded by means of the Internet. From a traditional perspective, fiscal jurisdiction is required for the

²⁶ Commission of Inquiry into certain Aspects of the Tax Structure of South Africa 1997 <http://www.polity.org.za/polity/govdocs/commissions/katz-5.html>

²⁷ South African Revenue Service 2000 Briefing Note Residence Basis of Taxation <http://www.sars.gov.za/legislation/Policy/2000/Briefing%20Note%20-%20Residence%20Basis%20of%20Taxation.pdf>

taxation of income.²⁸ Fiscal jurisdiction to tax electronic commerce transactions however is clouded as the Internet is not confined to a particular geographical or territorial fiscal jurisdiction.²⁹ Confusion would therefore exist as to which fiscal jurisdiction would have the right to tax a transaction.³⁰

For the traditional fiscal jurisdiction to be relevant in the electronic commerce environment, interpretation and development must take place to ensure that successful taxation of this global electronic market be confidently catered for. Many attempts to reformulate the traditional principles to cater for electronic commerce have been explored.³¹ Whether these attempts lead to reformulating source rules, extending residence rules, altering the permanent establishment concept, imposing a formulary apportionment approach, improving information exchange or going to the extreme of implementing a world-wide remit, taxing the Internet will become an important consideration for all taxing authorities.³² Although the physical world still provides the infrastructure for the communications networks and, for physical products, the methods for delivery of those products that are purchased, the Internet poses challenges for the tax base of South Africa.³³

The threat to the South African tax base stems from a growing number of traditional transactions that are being replaced by electronic commerce transactions.³⁴ For South Africa this will mean that the:

...[t]ax authorities will have to adapt their application of existing tax principles, practices and procedures for an e-commerce environment. Alternatively, new methods of levying and collecting taxes will have to be

²⁸ Du Plessis "Taxation of E-commerce" 295-296.

²⁹ Du Plessis "Taxation of E-commerce" 297.

³⁰ Du Plessis "Taxation of E-commerce" 295-296.

³¹ Bird 2005 *Bulletin for International Fiscal Documentation* 136 – 137. See further McLure 2003 *Bulletin for International Fiscal Documentation* 146 and Cockfield 2002 *Bulletin for International Fiscal Documentation* 606.

³² Bird 2005 *Bulletin for International Fiscal Documentation* 136 – 137.

³³ Oguttu and Van der Merwe 2005 *SA Mercantile Law Journal* 306.

³⁴ Oguttu and Van der Merwe 2005 *SA Mercantile Law Journal* 306.

devised. Taxpayers, on the other hand, will have to adapt their tax planning strategies and consider the impact of a changing business environment on their global tax charge.³⁵

The adaptation of the application of existing principles is not without its problems. In 1992, the United Kingdom tax authorities identified three areas in which electronic commerce would pose challenges to tax authorities: tax administration, compliance and tax evasion issues, and the question whether new rules for taxation should be developed.³⁶ These three challenges have been said to “raise a more fundamental issue”.³⁷ The more fundamental issue that is raised is the principle of fiscal jurisdiction. It is the more fundamental issue of fiscal jurisdiction that allows for an “open, accountable and fair taxation of profits derived from e-Commerce”.³⁸

This study will address the more fundamental issue of fiscal jurisdiction and will explore whether an open, accountable and fair taxation of profits could exist for electronic commerce transactions in South Africa under the current principles of source and residence based taxation. An examination will therefore be made of the two central principles used to determine fiscal jurisdiction within South Africa, namely: the principles of source and residence based taxation. The examination will attempt to determine if South Africa will need to reformulate its source rules or extend its residence rules or alter its existing permanent establishment concept.

This study is undertaken because, at present, it is questionable whether South Africa’s existing income tax regime poses a legitimate tax base in respect of electronic commerce transactions. The existing South African income tax regime fails to address how its principles of fiscal jurisdiction would apply in the electronic commerce environment, leading to much speculation and debate.

³⁵ Du Plessis and Viljoen “Taxation of E-commerce: Income Tax” 231.

³⁶ Davis 2002 *Acta Juridica* 162.

³⁷ Davis 2002 *Acta Juridica* 162.

³⁸ Davis 2002 *Acta Juridica* 162.

Considerable debate has raged internationally, as in South Africa, on how, if at all, the principles of source and residence based taxation could be applied to the taxation of electronic commerce transactions. The very nature of the Internet's technical aspects has brought the application of traditional taxation principles under the spotlight and without proper directive on how, or if, fiscal jurisdiction is to be determined problems such as double taxation and non-taxation become real possibilities for electronic commerce transactions which, when conducted traditionally, would have been legitimately assigned to the South African tax base.³⁹

This study will therefore examine both the principles of source and residence based taxation as they exist in South Africa at present to determine if they could be adapted for electronic commerce transactions. The examination of these principles will be conducted in order to determine what the most appropriate method would be for South Africa to levy taxation on electronic commerce transactions, either by the principle of source or by the principle of residence based taxation or neither or both.⁴⁰ Although this study will not venture into the technical aspects of the Internet, a basic explanation of how the Internet came to be, how it operates and the application of electronic commerce by means of the Internet is required to fully understand why there are problematic international aspects at play when examining the principles of source and residence based taxation of electronic commerce transactions in South Africa.

³⁹ Bristol states that: "...developing countries would be net importers of e-commerce and hence will run a greater risk of losing tariff and tax revenues if traditional imports are replaced by online delivery. Therefore, the development of efficient tax collection systems for e-commerce should be a priority for all developing countries". See Bristol 2001 www.caricom.org/jsp/community/cota/e-commerce_tax_revenues_bristol.pdf Quite naturally, the development of efficient tax collection systems can only be devised after clarity has been reached regarding fiscal jurisdiction such as this study proposes to determine.

⁴⁰ This study will be limited to determining the suitability of only these two principles to the taxation of electronic commerce transactions within South Africa. The technical aspects of the application of either principle determined to be the most suitable will not be discussed or examined nor will any tax policy considerations be made. Further, this study shall be limited to the examination of the direct taxation of income despite reference to other forms of taxation which would, dependent on the context of their use, be comparative or illustrative. This study is therefore by no means meant to be exhaustive. All references in this study to the 'Act' will refer to the *Income Tax Act 58 of 1962 as amended up to, and including, the Taxation Laws Second Amendment Act 9 of 2007*.

2 Electronic commerce and its implications for taxation

2.1 Introduction

The Internet may be likened to the interconnected trade routes of China. The analogy between the silk roads and the Internet becomes more apparent when examining the definition of the Internet. The Internet, as defined under South African law, is an:

...interconnected system of networks that connects computers around the world using the TCP/IP...⁴¹

Developed in 1969 as a series of interconnected networks by the Advanced Research Projects Agency of the United States of America's Defence Department, the Internet was originally intended to create a series of interconnected networked computers. A distinct characteristic of this network was that, because messages could be routed or rerouted in more than one direction, the network could continue to function even if parts of it were destroyed, particularly if by a nuclear attack. The system that developed came to be known as ARPANET and was used by researchers at academic institutions; linking various institutions for research purposes.⁴² This interconnected network became known as the 'Internet' (short for 'interconnected networks'). The Internet is, however, only the 'backbone' of what is understood as the 'Internet' and is described by Doussy as the:

...logical and physical connections [that] make the Internet possible but the applications enable electronic commerce to take place over the Internet.⁴³

⁴¹ S 1 *Electronic Communications and Transactions Act* 25 of 2002.

⁴² Delta and Matsuura *Law of the Internet* (2nd ed) §1.02

⁴³ Doussy *The Taxation of Electronic Commerce and the Implications for Current Taxation Practices in South Africa* 19.

In 1989 the 'world wide web'⁴⁴ was invented by Tim Berners-Lee, Sam Walker and Robert Cailliau while working at CERN⁴⁵ in Geneva, Switzerland.⁴⁶ The 'world wide web' enables users to 'hyperlink'⁴⁷ from one source to another, regardless of the computer on which the information is stored or even that computer's location.⁴⁸ Mark Andreessen and his colleagues, developed a graphic interfaced called 'Mosaic' on which the 'world wide web' could be viewed by transforming the "digital information on web servers into multi media for desktop computers".⁴⁹ The use of these interconnected networks spread as desktop computers became household items and links to the Internet were opened to the public until it became, as it is known today, a "public, cooperative, and self-sustaining facility"⁵⁰ accessible to hundreds of millions of people worldwide.⁵¹

⁴⁴ Buys and Rothman "The Internet: an Overview" 13 defines the 'world wide web', 'www', or 'web' as being: "...currently the most popular on-ramp to the Internet's information and although the terms Web and Internet are often used synonymously, they are actually two different things. The Internet is the global association of computers that carries data and makes the exchange of information possible. The Web is a subset of the Internet – a collection of interlinked documents that work together using a specific Internet protocol called HTTP. Web documents use special links that take the form of highlighted or underlined text and graphics to link to other documents (referred to as hyperlinks). A hyperlink is a highlighted word or picture that, when clicked on, takes the user to another document on the same site or another site that might be hosted by a computer on the other side of the world". Defined further by www.wikipedia.org as: "...a system of interlinked, hypertext documents accessed via the Internet. With a web browser, a user views web pages that may contain text, images, videos, and other multimedia and navigates between them using hyperlinks". Wikipedia.org 2007 http://en.wikipedia.org/wiki/World_Wide_Web

⁴⁵ The European Organization for Nuclear Research, commonly known as CERN, is the world's largest particle physics laboratory situated just northwest of Geneva on the border between France and Switzerland. CERN is an international facility and as such its sites are not officially under Swiss or French jurisdiction. Wikipedia.org 2007 <http://en.wikipedia.org/wiki/CERN>

⁴⁶ Wikipedia.org 2007 http://en.wikipedia.org/wiki/World_Wide_Web

⁴⁷ A 'hyperlink' is defined by www.wikipedia.org as: "...a reference or navigation element in a document to another section of the same document or to another document that may be on a different website. Hyperlinks are part of the foundation of the World Wide Web created by Tim Berners-Lee, but are not limited to HTML or the web. Hyperlinks may be used in almost any electronic media". Wikipedia.org 2007 <http://en.wikipedia.org/wiki/Hyperlinking>

⁴⁸ Delta and Matsuura *Law of the Internet* (2nd ed) §1-10. See further www.wikipedia.org which provides the description of how the World Wide Web works as normally beginning: "...by typing the URL of the page into a web browser, or by following a hypertext link to that page or resource. The web browser then begins a series of communications, behind the scenes, in order to fetch and display it". Wikipedia.org 2007 http://en.wikipedia.org/wiki/World_Wide_Web

⁴⁹ Doussy *The Taxation of Electronic Commerce and the Implications for Current Taxation Practices in South Africa* 16.

⁵⁰ Whatis.com 2006 http://searchvb.techtarget.com/sDefinition/0,,sid8_gci212370,00.html

2.2 Defining 'electronic commerce'

It has become possible to trade via the internet in terms of a process which is now known as 'electronic commerce'.⁵² In a communication to the European Parliament, the Council, the Economic and Social Committee and the Committee of the Regions, a Commission tasked with investigating an European initiative in electronic commerce, considered electronic commerce to be a:

...fast moving and highly fluid environment, [in which] we are seeing the development of a wide array of innovative virtual businesses, markets and trading communities. Companies are now routinely outsourcing over the Internet functions such as order fulfilment and shipping to distributors which specialise in such services. Distributors themselves are "going virtual", outsourcing the physical warehouse and movement of goods to logistics specialists such as commercial courier companies. Buyers, sellers and intermediaries are forming industry-specific Internet markets in such diverse fields as real estate, automobile parts and construction equipment. Similarly, global manufacturing industries, such as automobiles, computers and aerospace, are actively integrating their supply chains through the Internet.⁵³

In April 2000, two definitions of 'electronic commerce' were endorsed by the Organisation for Economic Co-operation and Development ('OECD'). The first being a broad definition and the second being a narrow definition with both being

⁵¹ Van der Bruggen states that the: "*Internet and other information superhighways radically introduce new ways of communication, business teaching and living, ranging from the way international currency transactions are cleared between financial institutions to the way you buy a book*". See Van der Bruggen 2000

http://www.journal.au.edu/abac_journal/may00/ecomtax_2.doc See further Doussy *The Taxation of Electronic Commerce and the Implications for Current Taxation Practices in South Africa* 13 – 21 for a discussion on the history of the Internet and the World Wide Web, and the basics of the Internet and the World Wide Web. See also generally Chapter 3 of Doernberg and Hinnekens *Electronic Commerce and International Taxation*, for a discussion of technological changes and electronic commerce.

⁵² An expression coined by Lawrence Livermore in 1989. Doussy *The Taxation of Electronic Commerce and the Implications for Current Taxation Practices in South Africa* 21. See further Bristol who states that: "*Electronic commerce has become global in scope and by its nature will continue to expand on an international basis, transcending national boundaries and legal jurisdictions and creating business opportunities on a world-wide basis*". See Bristol 2001 www.caricom.org/jsp/community/cotale-commerce_tax_revenues_bristol.pdf

⁵³ Commission 1997 <ftp://ftp.cordis.europa.eu/pub/esprit/docs/ecomcom.pdf>

based on the communications infrastructure that is utilised by the transaction.⁵⁴

The broad definition describes 'electronic commerce transactions' as being:

...the sale or purchase of goods and services, whether between business, households, individuals, governments, and other public or private organizations, 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.

The narrow definition describes 'Internet transactions' as being:

...the sale or purchase of goods and services, whether between businesses, households, individuals, governments, and other public or private organizations, conducted over the internet. 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.

The OECD definitions identify the methods by which the order is placed or received as the determination of whether the transaction is an Internet transaction (conducted over the Internet) or an electronic transaction (conducted over computer-mediated networks) and not the payment or the channel of delivery.

During 2001, subsequent to the endorsement of the two definitions, the OECD developed guidelines for interpreting these definitions.⁵⁵ Both of the guidelines further quantify Internet and electronic commerce transactions by providing a clearer idea of the process attributed to each. The broad definition would include orders received or placed on any online application used in automated transactions such as Internet applications, EDI, Minitel or interactive telephone systems.⁵⁶ The narrow definition, however, includes orders received or placed on

⁵⁴ *Measuring the Information Economy* p 89. See Organisation for Economic Co-operation and Development 2002 <http://www.oecd.org/dataoecd/16/14/1835738.pdf>.

⁵⁵ *Measuring the Information Economy* p 89. See Organisation for Economic Co-operation and Development 2002 <http://www.oecd.org/dataoecd/16/14/1835738.pdf>.

⁵⁶ *Measuring the Information Economy* p 89. See Organisation for Economic Co-operation and Development 2002 <http://www.oecd.org/dataoecd/16/14/1835738.pdf>.

any Internet application used in automated transactions such as web pages, extranets, and other applications that run over the Internet, such as EDI over the Internet, Minitel over the Internet, or over any other web enabled application regardless of how the web is accessed (e.g. through a mobile telephone or television set) however, it would exclude orders received or placed by telephone, facsimile or conventional electronic mail.⁵⁷

It is therefore submitted that the following definition of electronic commerce can be gleaned from the abovementioned definitions and guidelines. Electronic commerce is the sale or purchase, of goods or services, on any Internet application used in automated transactions, consisting of a web enabled application, regardless of the manner in which it is accessed, and for which the payment and delivery of such product is either on or offline.⁵⁸

Electronic commerce covers mainly two types of activities: indirect electronic commerce,⁵⁹ and direct electronic commerce.⁶⁰ Both indirect and direct electronic commerce offer specific opportunities to be considered. The same businesses could make use of both types, for example, by selling software 'off the shelf' that would be 'delivered' by using an international courier and by selling software online that would be 'delivered' by downloading it.⁶¹ Electronic commerce therefore could potentially encompass an extensive range of products by means of e-procurement involving Internet based sales transactions, online catalogues displaying images of goods that are available for purchase from around the

⁵⁷ *Measuring the Information Economy* p 89. See Organisation for Economic Co-operation and Development 2002 <http://www.oecd.org/dataoecd/16/14/1835738.pdf>.

⁵⁸ This constructed definition will be the one preferred by the writer for this study.

⁵⁹ Indirect electronic commerce is the electronic ordering of tangible goods, which still must be physically delivered using traditional channels such as postal services or commercial couriers. See Commission 1997 <ftp://ftp.cordis.europa.eu/pub/esprit/docs/ecomcom.pdf>

⁶⁰ Direct electronic commerce is the online ordering, payment and delivery of intangible goods and services such as computer software, entertainment content or information services on a global scale. See Commission 1997 <ftp://ftp.cordis.europa.eu/pub/esprit/docs/ecomcom.pdf>

⁶¹ Indirect electronic commerce is, however, dependent on a number of external factors, such as the efficiency of the transport system whereas direct electronic commerce enables seamless, end-to-end electronic transactions across geographical boundaries promoting the exploitation of the full potential of this global electronic market. See Commission 1997 <ftp://ftp.cordis.europa.eu/pub/esprit/docs/ecomcom.pdf>

world, further goods such as computer software which is transferred electronically; photographs that are transferred digitally, online information as sold effortlessly by means of electronic commerce. Electronic commerce also encompasses an extensive range of services such as legal, accounting, medical, and other consulting services that are accessed by means of passwords for a fee, video conferencing, securities trading and offshore banking.⁶² All these goods and services are examples of what is being traded in what has become known as a 'borderless' community.

2.3 *Electronic commerce's implications for taxation*

Hellerstein quotes Jeffrey Owens in stating that the trading of goods and services by means of electronic commerce has given rise to six attributes.⁶³ These six attributes are:

1. the ability to establish public and private global communications systems that are secure and inexpensive to operate;
2. the process of 'disintermediation' whereby the Internet will eliminate or substantially reduce the need for intermediaries in the sale and delivery of goods and services, and in the provision of information;
3. the development of encrypted information that protects the confidentiality of the information transmitted on the Internet;
4. an increased scope for the integration of business functions;
5. greater flexibility in the choice of the organisation form by which an enterprise carries out its international activities; and
6. the fragmentation of economic activity.

Owens' six attributes ('Owens' six attributes') have implications for the taxation of electronic commerce transactions. The start-up capital requirements for the Internet will make it easier for smaller business to operate and engage in cross

⁶² Hellerstein 2002 http://www.wto.org/english/tratop_e/devel_e/sem05_e/hellerstein.doc

⁶³ Hellerstein 2002 http://www.wto.org/english/tratop_e/devel_e/sem05_e/hellerstein.doc

border activities and aided by the elimination or reduction of intermediaries, the Internet offers business the opportunity of directly reaching the marketplace.⁶⁴ With the greater flexibility in the choice of organisation forms taxing authorities will be hampered by the ability to encrypt information and the location of the various participants to a transaction.⁶⁵ Attributes such as those identified by Owens will make the taxation of electronic commerce increasing difficult, more so in the future as technology evolves for, as the Katz Commission contends, electronic commerce has provided:

...much evidence regarding a not too distant future where international trade investment will increasingly become a function of global electronic communication such as through the Internet. There is no doubt that these developments will greatly impact on some of the basic tenets of international taxation as they exist today.⁶⁶

The basic tenets of international taxation allow not only a 'home' fiscal jurisdiction to tax its resident when that resident has earned income from economic activity in a 'host' fiscal jurisdiction but also allows that 'host' fiscal jurisdiction to tax the same income.⁶⁷ The 'home' fiscal jurisdiction will be permitted to tax based on the principle of residence and the 'host' fiscal jurisdiction will be permitted to tax based on the principle of source.⁶⁸ Whilst the applications of these two principles have been well established in both South African and international taxation systems for application to conventional transactions, their applications to that of electronic commerce transactions have yielded largely inconsistent application. Inconsistent application of taxation contravenes a fundamental tenet of taxation, namely: neutrality. Neutrality requires that the rules of taxation should not:

⁶⁴ Consider the direct sales opportunities that airlines have for ticket sales over the Internet. Hellerstein 2002 http://www.wto.org/english/tratop_e/devel_e/sem05_e/hellerstein.doc

⁶⁵ Hellerstein 2002 http://www.wto.org/english/tratop_e/devel_e/sem05_e/hellerstein.doc

⁶⁶ Commission of Inquiry into certain Aspects of the Tax Structure of South Africa 1997 <http://www.polity.org.za/polity/govdocs/commissions/katz-5.html>

⁶⁷ Basu 2001 http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2001_2/basu1

⁶⁸ How taxation occurs is varied and dependant on the existence of double taxation agreements or foreign tax credits would determine how an income would be taxed..

...affect economic choices and that, therefore, economically similar incomes should be taxed similarly. That is to say that the same taxation principles that apply to income from conventional ways of conducting business should also apply to those from E-commerce transactions.⁶⁹

Applying conventional taxation principles to transactions concluded by means of electronic commerce is not an easy feat. Businesses that operate through the Internet, or 'virtual corporations', have a great deal more flexibility to locate or relocate in fiscal jurisdictions with favourable income tax rules and rates as it is easier to manipulate the location of computer servers, headquarter employees, or information technology personnel than it is to locate or relocate factories.⁷⁰

For South Africa, as for the international community, the difficulty will be in determining if this global electronic market, which is emerging from telecommunication developments, will be able to conform to the conventional principles of source and residence based taxation currently in place within South Africa.⁷¹ Perhaps this global electronic market that has broken down the economic barriers between fiscal jurisdictions and has encouraged international trade will require new principles or require conventional principles to be adapted to suit it.⁷²

Within South Africa, the conventional principles to exercise fiscal jurisdiction over an income provide that income must conform to the definition of a "gross income"

⁶⁹ Basu 2001 http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2001_2/basu1

⁷⁰ Van der Bruggen states that: "Tax laws traditionally concentrate on concepts of physical business location, effective management and residence to decide which country should tax income arising from international business transactions, and which country may not. These concepts seem difficult to apply in the case of electronic commerce, where there are no offices required, nor a shop or even a warehouse in many cases. There is no way to determine where, if any, management is located nor does the user know what is the place of residence of his correspondent". See Van der Bruggen 2000 http://www.journal.au.edu/abac_journal/may00/ecomtax_2.doc See further Basu 2001 http://www2.warwick.ac.uk/fac/soc/law/elj/jilt/2001_2/basu1

⁷¹ Oguttu and Van der Merwe 2005 *SA Mercantile Law Journal* 305.

⁷² Oguttu and Van der Merwe 2005 *SA Mercantile Law Journal* 305. See further Bristol who states that: "Globalization and specifically liberalization of communication networks have all facilitated this break-through that further presents a massive boost for international trade". See Bristol 2001 www.caricom.org/jsp/community/cota/e-commerce_tax_revenues_bristol.pdf

as defined in the *Income Tax Act 58 of 1962* (the "Act"). Section 1 of the Act clearly defines "gross income" as being:

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

To provide sufficient answers for how electronic commerce is to be taxed, the definition of gross income in Section 1 of the Act, which encompasses the hybrid nature of the South African principles of source and residence, must be addressed. Contained within paragraph a of the gross income definition in Section 1 of the Act is the test to be imposed for residents and contained within paragraph b of the gross income definition in Section 1 of the Act is the test to be imposed for non-residents. Each of these tests have potential applications to the Internet and transactions conducted by means of electronic commerce. It is to these potential applications within the electronic commerce environment that this study now turns.

3 The principle of source based taxation as applied to electronic commerce

3.1 Introduction

The principle of source based taxation is the right to levy taxation on income generated within the borders of a territorial jurisdiction.⁷³ The justification for source based taxation is that a territorial jurisdiction has the right to tax “income arising within its jurisdiction regardless of the residence of the taxpayer”.⁷⁴ In *Kergeulen Sealing and Whaling Co., Ltd v CIR*,⁷⁵ Stratford CJ observed that the principle underlying the liability for levying taxation on the basis of source rested on the assumption that:

...a country that produces wealth by reason of its natural resources or the activities of its inhabitants is entitled to a share of that wealth, wherever the recipient of it may live.⁷⁶

The term ‘source’ however is, problematically, without definition in South African legislation. Refusing to assist with a definition for the term ‘source’, the Katz Commission remarked that it was not in favour of attempting a detailed definition of a phenomenon that, in the hands of endlessly creative entrepreneurs, could have as many variables as international commerce and investment.

3.2 Judicial precedent defining the term ‘source’

The lack of a definition for the term ‘source’ has led to much analysis in case law for the appropriate interpretation that is to be attributed to it. Various analyses by South African courts have, over the years, resulted in decisions that

⁷³ Oliver and Honiball *International Tax* (2005) 43.

⁷⁴ Larking *International Tax Glossary* 262 – 263. See further Van der Bruggen 2000 http://www.journal.au.edu/abac_journal/may00/ecomtax_2.doc

⁷⁵ *Kergeulen Sealing and Whaling Co., Ltd v Commissioner for Inland Revenue* 1939 AD 487.

⁷⁶ *Kergeulen Sealing and Whaling Co., Ltd v Commissioner for Inland Revenue* 1939 AD 487 at 507. See further Meyerowitz *Meyerowitz on Income Tax 2005 – 2006* §7.11.

indicate tests, factors and considerations that should be applied in deciding the source of an income. Despite these decisions the formulation for a universal test to determine the source of an income is, as Watermeyer CJ remarks in *CIR v Lever Bros. and Another*,⁷⁷ probably an impossible task.⁷⁸ Further, in *Rhodesia Metals Ltd (in Liquidation) v COT*,⁷⁹ De Villiers JA (quoting a judgement of Isaacs J in the Australian case *Nathan v F.C. of Taxes* 25 C.L.R 183), went so far as to deny that the term 'source' was even a legal concept.⁸⁰ De Villiers JA stated simply that the actual source of an income was a practical matter of hard fact and was something that a practical man would regard as the real source of income.⁸¹ Quite fundamentally, it is to be noted that 'source' denotes origin, and not location.⁸² Further, capital which produces an income is located where it is employed.⁸³ As a result, the source of any income is the business, capital or service which produces the income.⁸⁴

Preferring the phrase "originating cause" for the source of income,⁸⁵ Watermeyer CJ stated in *CIR v Lever Bros. and Another* that when determining the source of income for the purposes of determining a taxpayer's gross income a two-prong test arises. The first leg of this two-prong test is to determine the originating cause of the income and the, second, to determine the territorial jurisdiction in

⁷⁷ *Commissioner for Inland Revenue v Lever Bros., and Another* 1946 AD 441.

⁷⁸ *Commissioner for Inland Revenue v Lever Bros., and Another* 1946 AD 441 at 454.

⁷⁹ *Rhodesia Metals Ltd (in Liquidation) v COT* 1938 AD 282.

⁸⁰ *Rhodesia Metals Ltd (in Liquidation) v COT* 1938 AD 282. See further *Commissioner for Inland Revenue v Lever Bros., and Another* 1946 AD 441 at 454.

⁸¹ *Rhodesia Metals Ltd (in Liquidation) v COT* 1938 AD 282.

⁸² *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 1926 AD 444 at 453. See further *Commissioner for Inland Revenue v Lever Bros., and Another* 1946 AD 441 at 453.

⁸³ *Overseas Trust Corporation Ltd v Commissioner for Inland Revenue* 1926 AD 444 at 453 – 454. See further *Commissioner for Inland Revenue v Lever Bros., and Another* 1946 AD 441 at 453.

⁸⁴ *Commissioner for Inland Revenue v Lever Bros., and Another* 1946 AD 441 at 453.

⁸⁵ *Commissioner for Inland Revenue v Lever Bros., and Another* 1946 AD 441 at 449 - 450. Watermeyer CJ stated that a series of decisions had interpreted the term 'source'. From those decisions, Watermeyer CJ inferred that what should be drawn from them was that the source of receipts, received as income, is "not the quarter whence they come, but the originating cause of their being received as income". See *Commissioner for Inland Revenue v Lever Bros., and Another* 1946 AD 441 at 450.

which the activities that gave rise to the income were conducted.⁸⁶ Practically, the first leg of the test would determine the activity that generated the income, whether business, capital or service, followed by the second leg of the test, to determine the location of such activity for the purposes of taxation. Should the originating cause be split between multiple locations then the “dominant or main or substantial or real and basic cause of the accrual of income” must be determined.⁸⁷ The originating cause of the income will then be where the dominant source of the income is located.⁸⁸

3.3 Applying the term ‘source’ to the electronic commerce environment

As with traditional activities, the two-prong test is the foundation for an inquiry into determining the source of activities that result from electronic commerce transactions. This enquiry is a difficult task as the originating cause of income is traditionally linked to a specific geographical location where a taxpayer’s activities would take place.⁸⁹ The rise of the Internet has meant that:

...e-commerce transactions can generate income without substantially using infrastructure in any given physical location. Information technology has also made it possible for businesses to decentralise and to spread their functions (such as financial, administrative, marketing, sales, delivery and customer support) across various jurisdictions to yield the greatest return on investment and to provide in the need of remote customers.⁹⁰

The case of *Kergeulen Sealing and Whaling Co., Ltd v CIR* does have similarities to an electronic commerce transaction. In *Kergeulen Sealing and Whaling Co., Ltd v CIR*, the court was faced with the dilemma of deciding whether an income was derived from a source within the Union, or deemed to be within the Union,

⁸⁶ *Commissioner for Inland Revenue v Lever Bros., and Another* 1946 AD 441 at 449 per Watermeyer CJ. See further Olivier and Honiball *International Tax* (2005) 45.

⁸⁷ *CIR v Black* 1957 (3) SA 536 (A). Later confirmed by *Transvaal Associated Hides and Skin Merchants v COT* 29 SATC 97.

⁸⁸ Du Plessis “Taxation of E-commerce” 314.

⁸⁹ Oguttu and Van der Merwe 2005 *SA Mercantile Law Journal* 313.

⁹⁰ Oguttu and Van der Merwe 2005 *SA Mercantile Law Journal* 313 – 314.

from a company's whaling operations in the Antarctic Ocean.⁹¹ The problem was that the Antarctic Ocean is an area known as the "high seas", an area "open to all States".⁹² The Kergeulen Sealing and Whaling Co., Ltd was registered in Cape Town, where it also had its head office and its board of directors. Its business was the production and sale of whale oil derived from its whaling operations conducted by means of a "floating factory" and a fleet of whale catchers. As such, the operations which resulted in the production of oil were all carried out in the Antarctic Ocean, thereafter the oil was sold to purchasers outside the Union.

Not unlike the high seas, the Internet is "open to all States" and electronic commerce is not very different from a ship afloat on the high seas. As with the locality of the whaling operations, electronic commerce is conducted beyond the territorial jurisdiction of South Africa in the ordinary sense of the term. The question for electronic commerce therefore remains the same as it was for the principles behind an important and crucial question for the whaling operations of the ships in the Antarctic: are electronic commerce transactions to be regarded as part of the territory of South Africa for the purposes of applying the provisions of the Income Tax Act?⁹³

The findings of the court were that when the Legislature used the phrase "source within the Union" for the Act, this meant a source within the actual and fixed geographical limits of the South African territorial jurisdiction. Using the word "within" throughout the Act clearly indicated that an income could only be from a source "within South Africa" meaning its geographical confines.⁹⁴ Similarly, the Internet can therefore not produce income "within" South Africa as the Internet retains no actual or fixed geographical connection within the fiscal jurisdiction of

⁹¹ *Kergeulen Sealing and Whaling Co., Ltd v Commissioner for Inland Revenue* 1939 AD 487 at 494.

⁹² Article 87(1) of the United Nations Convention on the Law of the Sea.

⁹³ *Kergeulen Sealing and Whaling Co., Ltd v Commissioner for Inland Revenue* 1939 AD 487 at 506.

⁹⁴ *Kergeulen Sealing and Whaling Co., Ltd v Commissioner for Inland Revenue* 1939 AD 487 at 509.

South Africa.⁹⁵ With consideration for the traditional requirements set forth in case law, the principle of source based taxation cannot effectively cater for the electronic commerce environment. Where electronic commerce transactions are concluded and South Africa is the purchasing party,⁹⁶ the application of the requirements for locating the originating cause of an income would find that the originating cause of the income is not within South Africa's fiscal jurisdiction. Rather, the originating cause follows the activity that generated the income to its origin and such fiscal jurisdiction is to be the source of the income. The source of the income, if South African case law is followed, is the exercise of the taxpayer's wits, labour and skill and not the place where a contract is concluded.⁹⁷ Any activity that produces goods or services from a fiscal jurisdiction outside of South Africa and where those goods or services are then transacted by means of electronic commerce cannot have South Africa as its originating cause simply because it has a South African tax resident as its purchaser. Rather the source would be where the wits, labour and skill or capital were employed to generate the income.⁹⁸ In 2004, the Tax Court was asked to consider an appeal against a decision by the Commissioner of the South African Revenue Service which disallowed the appellant to set-off a financial loss. The appellant, a South African resident, was disallowed a set-off against his income of a financial loss that he had suffered as a result of his foreign exchange dealings which he carried on in his spare time over the Internet.⁹⁹ The Commissioner of the South African Revenue Service did so on the grounds that the loss was not as a result of a trade which was carried on within South Africa. The Tax Court accepted that certain elements of the trading took place outside of South Africa but upheld the appellant's appeal. The Tax Court found that it was the exercise of the

⁹⁵ This is based on the premise that no server is located within the fiscal jurisdiction of South Africa. For a discussion of servers as a basis for fiscal jurisdiction see the discussion of Permanent Establishment in Chapter Five.

⁹⁶ This study will make a difference between electronic commerce transactions where a party within South Africa is either the purchaser of goods and services or is the seller. As such, reference will be made to either a 'purchasing party' or a 'selling party'.

⁹⁷ *Millin v CIR* 1928 AD 207.

⁹⁸ *Millin v CIR* 1928 AD 207.

⁹⁹ ITC 1779 66 SATC 353.

appellant's wits and labour in making the crucial decisions for his transactions that played the essential role in his trading. As the exercise of the appellant's wits and labour was in South Africa so too was his trade. Blignault J stated further that the:

...application of the "dominant" or "main" or "substantial" or "real and basic" cause tests [...] would in my view lead to the same result.¹⁰⁰

The result being to find that the Appellant's activities in South Africa complied with the criteria which is required for a trade to take place within South Africa. Applied to a situation in which a business is operated by means of the Internet, cognisance of where the exercise of wits and labour to operate the business may be considered to be the dominant originating cause.

The problem does then exist with automated transactions in which no human intelligence makes decisions on a case by case basis, rather transactions are concluded and order's processed automatically by intelligent software located on one or more servers.¹⁰¹ The dominant originating cause of an activity might be sourced in South Africa if the server on which the web site was located, was within South Africa. This is to say, unless a server is fixed within the fiscal jurisdiction of South Africa, the traditional formulation of the principles of source based taxation cannot apply to the taxation of electronic commerce transactions in which South African residents are the purchasers of goods and services from a non-resident. However, a server, fixed within South Africa, on which a web site conducts electronic commerce could constitute a permanent establishment and leads to liability for taxation. The question therefore becomes: could a server, fixed within South Africa, from which electronic commerce is conducted fulfil the requirements for source based taxation by constituting a permanent establishment?

¹⁰⁰ ITC 1779 66 SATC 353 at paragraph 14.

¹⁰¹ Organisation for Economic Co-operation and Development Centre for Tax Policy and Administration 2006 <http://www.oecd.org/dataoecd/55/14/37861293.pdf>

4 The principle of residence based taxation as applied to electronic commerce

4.1 Introduction

The principle of residence based taxation is the right of a fiscal jurisdiction to levy taxation on the world-wide income generated by its tax resident.¹⁰² The justification for residence based taxation is that a resident:

...for the privilege and protection of residence, can justly be called upon to contribute towards the cost of good order and government of the country that shelters him.¹⁰³

South Africa moved from the principle of source based taxation to the principle of residence based taxation for years of assessment commencing from 01 January 2001.¹⁰⁴ The principle of residence based taxation enables the South African Revenue Service to levy taxation on South African residents on their worldwide income, meaning that, regardless of the source of the income, the South African Revenue Service has the fiscal jurisdiction to tax a resident's income.¹⁰⁵ The introduction in South Africa of the principle of residence based taxation was done to reap the following benefits:

1. It protects the South African tax base from exploitation by placing the income tax system on a sounder footing;

¹⁰² Oliver and Honnibal *International Tax* (2005) 51.

¹⁰³ *Kergeulen Sealing and Whaling Co., Ltd v Commissioner for Inland Revenue* 1939 AD 487 at 507 per Stratford CJ. See further Oliver and Honnibal *International Tax* (2005) 51; Van der Bruggen 2000 http://www.journal.au.edu/abac_journal/may00/ecomtax_2.doc

¹⁰⁴ South African Revenue Service 2000 Briefing Note Residence Basis of Taxation <http://www.sars.gov.za/legislation/Policy/2000/Briefing%20Note%20-%20Residence%20Basis%20of%20Taxation.pdf>

¹⁰⁵ South Africa's principle of residence based taxation is however a 'residence minus' system whereby certain categories of income and activities from sources outside South Africa will be exempt from South African taxation. See further South African Revenue Service 2000 Briefing Note Residence Basis of Taxation <http://www.sars.gov.za/legislation/Policy/2000/Briefing%20Note%20-%20Residence%20Basis%20of%20Taxation.pdf>

2. It brings the South African tax system more in line with international tax principles;
3. To relax exchange control, thereby ensuring greater offshore involvement of South African companies; and
4. The effective catering for taxation of e-commerce products, services and initiatives.¹⁰⁶

The fourth justification, the effective catering for taxation of electronic commerce, is of interest to this study. The interest lies in whether the transition from the principle of source to the principle of residence does, in fact, more effectively cater for the taxation of electronic commerce. To explore this interest, the principle of residence based taxation is considered in the light of electronic commerce.

The principle of residence based taxation is rooted in the taxation of a particular entity, either directly or indirectly, rather than in the taxation of a transaction, such as in the instance of source based taxation. A 'resident' of a particular fiscal jurisdiction is considered to be, for taxation purposes, a person who has "sufficiently close connections to a country to be liable for tax there on worldwide income".¹⁰⁷ Concentrating rather on a 'resident', the South African Revenue Services need only investigate a person's 'close connections' to the South African fiscal jurisdiction to determine whether they have sufficient reason to levy taxation, rather than delving into each separate transaction for its source before levying tax.¹⁰⁸

¹⁰⁶ South African Revenue Service 2000 Briefing Note Residence Basis of Taxation <http://www.sars.gov.za/legislation/Policy/2000/Briefing%20Note%20-%20Residence%20Basis%20of%20Taxation.pdf> See further Goosen *International Tax Planning: The Concept of Place of Effective Management* 05.

¹⁰⁷ Oliver and Honiball *International Tax* (2005) 488.

¹⁰⁸ Goosen *International Tax Planning: The Concept of Place of Effective Management* 05.

As the basis of the taxation, the concept of a 'resident' is to be defined. In terms of the gross income definition in Section 1 of the Act¹⁰⁹ the definition of a resident who is a natural person means any:

(a) natural person who is - (i) ordinarily resident in the Republic; or (ii) not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic – (aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and (bb) for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment, in which case that person will be a resident with effect from the first day of that relevant year of assessment...

Further, the gross income definition in Section 1 of the Act defines a resident who is other than a natural person as a:

(b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic; but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation.

As can be seen from the aforementioned definitions, South Africa recognises two types of residents, either a natural person or a juristic person, as residents for taxation of their worldwide income. For natural persons two tests are applied in the alternative, to determine whether they are residents as defined in the Act for taxation purposes. A natural person will be a resident either by being 'ordinarily resident' within South Africa or, alternatively, 'physically present' over a particular period within South Africa. For juristic persons, their residence is determined by incorporation, establishment or formation within South Africa, alternatively, if their place of effective management is determined to be within South Africa.

¹⁰⁹ As amended by the *Taxation Laws Amendment Act 8 of 2007* and the *Second Taxation Laws Amendment Act 9 of 2007*, both promulgated on 8 August 2007.

The determination of whether a natural person constitutes a resident of South Africa for taxation purposes can be objectively determined by the application of the two aforementioned alternative tests. Therefore, for the context of electronic commerce the residence of a natural person poses no new problems for the taxation of electronic commerce transactions.¹¹⁰ The residence of a person other than a natural person is, however, far more difficult to determine and is discussed further.

4.2 Electronic commerce and the taxation of persons other than natural persons

The difficulty of determining the residence of a juristic person in transactions of electronic commerce is as a result of the rapid development and progress of global telecommunications technology. Business activities can now be conducted effortlessly from around the globe in varying fiscal jurisdictions. Within South Africa, as was stated above, Section 1 of the Act defines a “resident other than a natural person” as:

...an entity incorporated, established or formed in South Africa or which has its place of effective management in South Africa.

The place of incorporation, establishment and formation provides a formal or *de jure* test for determining the fiscal residence of a juristic person.¹¹¹ Such formal or *de jure* test is based on the incorporation, establishment or formation of a juristic person providing a simple determination due to the statutory requirements of its registration.¹¹² The place of incorporation, establishment or formation of a juristic person may, however, not necessarily reflect the economic reality of the juristic

¹¹⁰ Buys *The Taxation of E-commerce from a South African Perspective*.

¹¹¹ Van der Merwe 2006 *SA Mercantile Law Journal* 121.

¹¹² Van der Merwe 2006 *SA Mercantile Law Journal* 121. See further Olivier and Honiball *International Tax* (2005) 54; Oguttu and Van der Merwe 2005 *SA Mercantile Law Journal* 310.

person “due to the ease of incorporation and lack of formal connecting factors for corporations in most jurisdictions”.¹¹³ It is therefore a serious consideration that the place of incorporation, establishment or formation would lack substance. Van der Merwe states that the place of incorporation, establishment or formation of a juristic person:

...need only reflect a formal connection and the location of this connection may initially be chosen quite randomly and freely by the taxpayer [...] open to manipulation as they could in theory be changed through a mere formal process without, in reality, changing the way in which the entity does business.¹¹⁴

Providing substance over form,¹¹⁵ the ‘place of effective management test’ provides a determinant that is less mechanistic.¹¹⁶ Although applicable to juristic persons concluding all types of transactions and not only to juristic persons concluding transactions in the electronic commerce environment, the place of effective management test provides the yardstick for determining the residence of juristic persons that transact by means of electronic commerce within South Africa’s fiscal jurisdiction.

The Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*, 1977, describes in Article 4 the “place of effective management” to be where:

...key management and commercial decisions that are necessary for the control of the enterprise’s business are in substance made.

¹¹³ Olivier and Honiball *International Tax* (2003) 54.

¹¹⁴ Van der Merwe 2006 *SA Mercantile Law Journal* 122.

¹¹⁵ Article 4(24) of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*, 1977, states that the place of effective management is the place where: “...key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made”. See Neves (ed) *OECD Model Tax Convention on Income and on Capital*. See further Van der Merwe 2006 *SA Mercantile Law Journal* 122.

¹¹⁶ Van der Merwe 2006 *SA Mercantile Law Journal* 121.

The place of effective management refers to a place where higher level management is conducted as opposed to day-to-day operations.¹¹⁷ The reasoning being that a juristic person may have more than one place of management but can truly only have one place of effective management.¹¹⁸

Within South Africa, the South African Revenue Service Interpretation Note 6 was introduced to provide guidance in the determination of the place of effective management for a juristic person.¹¹⁹ As the phrase 'place of effective management' is without definition in the Act, the Interpretation Note deals with the application of the phrase.¹²⁰ It provides limited effect as an interpretational aid and bodes to create undesirable confusion between the potential domestic and international interpretation of the phrase, place of effective management.¹²¹ The Interpretation Note, however, provides a general approach in which the place of effective management is described as the place where the juristic person:

...is managed on a regular or day-to-day basis by the directors or senior managers of the company, irrespective of where the overriding control is exercised, or where the board of directors meets.¹²²

¹¹⁷ Olivier, Honiball and Brincker *International Tax* (2003) 312.

¹¹⁸ Davis 2002 *Acta Juridica* 163.

¹¹⁹ South African Revenue Service Interpretation Note 6 dated 26 March 2002. See South African Revenue Service 2002

<http://www.sars.gov.za/it/Interpretation%20Notes/Interpretation%20Note%206%20-%20Resident%20Place%20of%20effective%20management%20-%2026%20March%202002.pdf> See further Olivier and Honiball *International Tax* (2005) 55.

¹²⁰ The phrase 'place of effective management' is however not comprehensively defined within the South African Revenue Service Interpretation Note 6. What the Interpretation Note attempts to advance is the interpretation of the phrase 'place of effective management' by providing a General Approach. Such general approach is assisted by an introduction, practical application and a non-exhaustive list of relevant facts and circumstances. For a comprehensive discussion of the phrase 'place of effective management' and for an analysis of the Interpretation Note's various elements with a reflection of the Interpretation Notes effectiveness, see further generally Van der Merwe 2006 *SA Mercantile Law Journal* 121 – 137. See further also Olivier and Honiball *International Tax* (2005) 54 – 58.

¹²¹ Van der Merwe 2006 *SA Mercantile Law Journal* 137.

¹²² South African Revenue Service 2002
<http://www.sars.gov.za/it/Interpretation%20Notes/Interpretation%20Note%206%20-%20Resident%20Place%20of%20effective%20management%20-%2026%20March%202002.pdf>

In terms of this general approach taken by the Interpretation Note, the place of effective management will be the place where the policy and strategy decisions are executed and implemented, not the place where they are taken.¹²³ The Oxford Advanced Learner's Dictionary declares the word "execute" to mean "(a) to put something into effect" and declares "implement" to mean: "to put something into effect; to carry something out".¹²⁴ The place where the entity's overall group vision and objectives are put into effect is therefore the place of effective management.

Practically applied, the Interpretation Note provides three alternative tests through which a single residence for a juristic person could be determined.¹²⁵

The three alternative tests are as follows:

1. The 'pure norm' test.¹²⁶ Where the regular, day-to-day management exists in a single location, this will be the place of effective management, whether or not it corresponds with the place where the daily business operations are actually conducted or carried out.¹²⁷
2. The 'deemed place of effective management' test.¹²⁸ Where the management functions are not executed at a single location due to management by way of distance communication, the place of effective management must be deemed to be where day-to-day operational

¹²³ South African Revenue Service 2002
<http://www.sars.gov.za/it/Interpretation%20Notes/Interpretation%20Note%206%20-%20Resident%20Place%20of%20effective%20management%20-%2026%20March%202002.pdf>. See further Olivier and Honiball *International Tax* (2005) 55.

¹²⁴ Crowther (ed) *Oxford Advanced Learner's Dictionary of Current English* 401 and 595 – 596 respectively.

¹²⁵ Van der Merwe 2006 *SA Mercantile Law Journal* 127.

¹²⁶ Van der Merwe 2006 *SA Mercantile Law Journal* 128.

¹²⁷ South African Revenue Service 2002
<http://www.sars.gov.za/it/Interpretation%20Notes/Interpretation%20Note%206%20-%20Resident%20Place%20of%20effective%20management%20-%2026%20March%202002.pdf> See further Van der Merwe 2006 *SA Mercantile Law Journal* 128; Olivier and Honiball *International Tax* (2005) 55.

¹²⁸ Van der Merwe 2006 *SA Mercantile Law Journal* 128 – 129.

management and commercial decisions taken by senior managers are actually implemented.¹²⁹

3. The 'strongest economic nexus' test.¹³⁰ Where the business operations or activities are conducted from various locations requiring the determination of the place with the strongest economic nexus.¹³¹

The 'deemed place of effective management' test is devised to make provision for the problematic nature of modern technology.¹³² Attempting to address the complications that arise from the nature of the Internet where the determination of a single location from which the management functions of a juristic person have been put into effect, the place of effective management is then deemed to be where actual implementation occurs. Failing to determine a single location from the deemed place of effective management test, the Interpretation Note provides a final test, the 'strongest economic nexus' test. Unfortunately, the 'strongest economic nexus' test is not explained in the Interpretation Note, however:

...it is not a new invention and, depending on the context and meaning attached to it, it may have had its origin in the theory of economic allegiance. It was also more recently referred to by the OECD as a possible alternative for the replacement of effective management, or as one element in a hierarchy of tie-breaker tests.¹³³

The advent of the Internet has meant that the management functions of a juristic person can take place effectively by means of video conferencing technology.

¹²⁹ South African Revenue Service 2002
<http://www.sars.gov.za/it/Interpretation%20Notes/Interpretation%20Note%206%20-%20Resident%20Place%20of%20effective%20management%20-%2026%20March%202002.pdf> See further Van der Merwe 2006 *SA Mercantile Law Journal* 128 – 129; Olivier and Honiball *International Tax* (2005) 55.

¹³⁰ Van der Merwe 2006 *SA Mercantile Law Journal* 129.

¹³¹ South African Revenue Service 2002
<http://www.sars.gov.za/it/Interpretation%20Notes/Interpretation%20Note%206%20-%20Resident%20Place%20of%20effective%20management%20-%2026%20March%202002.pdf> See further Van der Merwe 2006 *SA Mercantile Law Journal* 129; Olivier and Honiball *International Tax* (2005) 55.

¹³² Van der Merwe 2006 *SA Mercantile Law Journal* 128.

¹³³ Van der Merwe 2006 *SA Mercantile Law Journal* 129.

The utilisation of this technology can be applied when conducting the day-to-day management functions with directors and senior managers located throughout the world.¹³⁴ For this reason, it may be necessary to refine the place of effective management test so as to have more weight assigned to the:

...functions performed within each country as well as the determination of where the majority of directors or senior managers reside, or alternatively, those who, in the final analysis, 'call the shots'. The only other viable test to determine the residence of a person other than a natural person is to determine where the economic nexus is strongest.¹³⁵

The factors of production, namely: land, labour, capital and enterprise may become the important economic connectors to be utilised when taxing electronic commerce.¹³⁶ This might mean that the fiscal jurisdiction that has the strongest economic nexus with the juristic person will be the one to tax it.¹³⁷ The technical advisory group of the OECD, on monitoring the application of existing treaty norms to taxation of business profits, set out in February 2001 the difficulties of the strongest economic nexus test in a discussion paper stating that while:

...on the surface it may appear that such an option is more aligned to source taxation rationale, it also may have some links to the underlying rationale for residence taxation. It could be argued that the state provides certain facilities and infrastructure for its residents, those who benefit most from such facilities and infrastructure ought to contribute to the State via residence-based taxes. So if a company uses the legal infrastructure, consumes or uses the facilities etc in that State, there is a case that it ought to be treated as a resident. If it does so in more than one State then a tie-breaker rule based on economic nexus would require a determination (as with individuals) of where its ties/consumption are stronger. However, it could also be argued that the use by a company of the facilities and infrastructure of a State is a rationale that supports source, rather than residence, taxation. Nevertheless, the concept of economic nexus could still be used as a tie-breaker even if it is not used as a basis for residence taxation. It should be noted that such a concept being used in a residence tie-breaker is not

¹³⁴ Collett 2003 *University of New South Wales Law Journal* 622.

¹³⁵ Davis 2002 *Acta Juridica* 164.

¹³⁶ Davis 2002 *Acta Juridica* 164.

¹³⁷ Davis 2002 *Acta Juridica* 164.

unprecedented. For example, the individual tie-breaker uses “*centre of vital interests*” as a determining factor in deeming residence.¹³⁸

Developing a new test of fiscal residence for a juristic person that aligns itself more with that in the individual’s tie breaker test, a proposition has been made by Matthew Collett.¹³⁹ Collett proposes that a new article 4(3) be inserted into the *OECD Model Tax Convention on Income and on Capital*, 1977, whereby multinational enterprises have their residence determined by examining first their centre of vital interests; thereafter the state in which they habitually locate and manage their most significant functions, assets and risks; with finally their incorporation as the last alternative test to deem residence. In a situation of dual residence conflict the centre of vital interests test deems a taxpayer to be the resident of only the fiscal jurisdiction in which the personal and economic relations are closer. Listing the considerations to be an individual’s family and social relations, occupations, political, cultural or other activities, place of business; place where the individual administers property and the location at which possessions are held. Collett suggests that while a company does not have personal relations it does have “other economic, political, cultural and legal links”.

To take Collett’s suggested alternative test of fiscal residence for juristic persons a step further and apply it to electronic commerce a suitable test for the ‘strongest economic nexus’ may be found. Such a test may prevent the manipulation of electronic commerce transactions and provide clarity for fiscal jurisdiction by examining where a juristic person, engaging in electronic commerce, is deemed to have its strongest economic ties. The strongest economic ties may be in a fiscal jurisdiction in which the greatest use of facilities or legal and economic infrastructure exists.¹⁴⁰ Although a daunting task to

¹³⁸ Organisation for Economic Co-operation and Development Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits 2001 <http://www.oecd.org/dataoecd/46/27/1923328.pdf>

¹³⁹ Collett 2003 *University of New South Wales Law Journal* 622 – 638.

¹⁴⁰ Collett 2003 *University of New South Wales Law Journal* 631.

quantify these activities, the strongest economic nexus test, as suggested by the Interpretation Note, provides a potentially viable way for the fiscal jurisdiction that has the strongest economic nexus with the juristic person engaging in electronic commerce transactions to be the one to tax the income.¹⁴¹

¹⁴¹ Davis 2002 *Acta Juridica* 164.

5 Electronic commerce and the concept of 'permanent establishment'

5.1 Introduction

The concept of 'permanent establishment' has held the attention of "tax officialdom" in the real world and has been described as one of the most important issues in treaty based international fiscal law, perhaps the single most important one.¹⁴² The permanent establishment concept has been a salient area of focus in which possible adaptation for the electronic commerce environment could arise.

Under a double taxation agreement, the concept of a 'permanent establishment' is used to determine whether a resident of one fiscal jurisdiction has a taxable presence within another fiscal jurisdiction.¹⁴³ As defined in the *OECD Model Tax Convention on Income and on Capital* a "permanent establishment" is "a fixed place of business through which the business of an enterprise is wholly or partly carried on".¹⁴⁴ In its most basic form a permanent establishment is an entity that is commercially separate from its head office whilst still being a legally integrated business enterprise where, in some cases, it performs the entire business of its head office as if it were a single purpose company.¹⁴⁵ In terms of the OECD

¹⁴² Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* 01.

¹⁴³ Du Plessis "Taxation of E-commerce" 301.

¹⁴⁴ Article 5(1) of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*, 1977. See Neves (ed) *OECD Model Tax Convention on Income and on Capital*. See further Larking *International Tax Glossary* 262 – 263 which describes a 'permanent establishment' as: "...a non-resident's business presence in a particular country which is of a sufficient level to justify that country's taxation of the attributable profits. The term is most commonly used in tax treaties but may also be found in some countries' domestic tax laws. In some cases other expressions may be used having a similar but not necessarily identical meaning, e.g. a branch (UK), or permanent representative. When used in the context of tax treaties, a permanent establishment is generally constituted by a fixed place of business in the source country through which the business of an enterprise is wholly or partly carried on, but may also be constituted in certain circumstances by virtue of the activities carried on in the source country by a dependant agent, sometimes referred to as an agency permanent establishment". See also McLure 2002 http://www.law.wayne.edu/mcintyre/text/mclure_EU-e-comm.pdf; Van der Bruggen 2000 http://www.journal.au.edu/abac_journal/may00/ecomtax_2.doc

¹⁴⁵ Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* 01 – 02.

*Model Tax Convention on Income and on Capital*¹⁴⁶ a foreign company is not liable for tax in its host state unless it has created a permanent establishment within it,¹⁴⁷ and then only the profits that are attributable to that permanent establishment may be taxed.¹⁴⁸

5.2 The fundamentals of the permanent establishment concept as applied to electronic commerce

The permanent establishment concept is designed to encourage international trade by providing clarity as to the level of presence required for an entity to be taxable on trading profits arising within fiscal jurisdictions party to a double taxation agreement.¹⁴⁹ The requisite level of presence is subjected to what Skaar states to be the “fixed place of business” test.¹⁵⁰ The “fixed place of business” test is comprised of three requirements, namely:

1. That a ‘place of business’ must exist;
2. That the right to use such ‘place of business’ must be maintained with a certain degree of permanence; and

¹⁴⁶ Article 7(1) of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*, 1977 states that: “[t]he profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated herein.”. See Neves (ed) *OECD Model Tax Convention on Income and on Capital*.

¹⁴⁷ Article 7(1) of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*, 1977. See Neves (ed) *OECD Model Tax Convention on Income and on Capital*. See further Saunders et al *The Principles of International Tax Planning* 226; Olivier and Honnibal *International Tax* (2005) 73; Cockfield 2002 *Bulletin for International Fiscal Documentation* 608.

¹⁴⁸ Article 7(1) of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*, 1977. See Neves (ed) *OECD Model Tax Convention on Income and on Capital*. See further Olivier and Honnibal *International Tax* (2005) 73.

¹⁴⁹ Cockfield states that the: “...traditional concept of a permanent establishment is tied, in part, to the notion that multinational companies would not bother to incur significant marginal costs in a foreign market (such as through the use of a retail sales outlet) unless the companies anticipated significant profits in the foreign market”. Cockfield further states that the: “...traditional permanent establishment hence acts as evidence that more than de minimis economic activity is taking place in the source country and that this country should be entitled to tax profits attributable to the permanent establishment”. See Cockfield 2002 *Bulletin for International Fiscal Documentation* 608.

¹⁵⁰ Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* 111.

3. That such 'place of business' must be at a distinct geographical place within a fiscal jurisdiction.¹⁵¹

These three requirements are placed under pressure when examining electronic commerce transactions. Most definitions of a permanent establishment emphasise the need for a physical or natural resource in the host fiscal jurisdiction. Skaar describes this need as perhaps the most crucial part of the permanent establishment concept and states that a permanent establishment:

...should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country.¹⁵²

Until the Internet, many economic activities have required the physical presence of employees or an agent in a fiscal jurisdiction to establish a permanent establishment. To an increasing degree, the Internet allows economic activities to be conducted by a purely electronic presence in the form of a web site with no more than a server in a foreign fiscal jurisdiction.¹⁵³ This problem has prompted changes to Article 5 of the Commentary on the OECD *Model Tax Convention on Income and on Capital*, 1977,¹⁵⁴ which states that:

...a web site cannot, of itself, constitute a permanent establishment, that web site hosting arrangement typically does not result in a permanent establishment for the enterprise that carries on business through that web site and that an ISP will not, except in very unusual circumstances,

¹⁵¹ Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* 111 – 112. See further Bach, Hubbert and Müller 2000 *Vierteljahrshefte zur Wirtschaftsforschung* 663.

¹⁵² Skaar *Permanent Establishment: Erosion of a Tax Treaty Principle* 112.

¹⁵³ Inserted paragraph 42.2 of Article 5 of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*. See Organisation for Economic Co-operation and Development Committee on Fiscal Affairs 2000 <http://www.oecd.org/dataoecd/46/32/1923380.pdf>

¹⁵⁴ The Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*, 1977, forms the basis of the extensive network of bilateral income tax treaties between OECD member countries and between many OECD member and non-member countries and Article 7 of the said convention provides the international tax principles for attributing profits to a permanent establishment. See further Organisation for Economic Co-operation and Development Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits 2001 <http://www.oecd.org/dataoecd/46/32/1923380.pdf>

constitute a dependant agent of another enterprise so as to constitute a permanent establishment of that enterprise.¹⁵⁵

The decision that a web site cannot, of itself, constitute a permanent establishment is based on the consideration that a web site, being only a combination of software and electronic data, does not constitute tangible property.¹⁵⁶ Not being tangible property, a web site cannot have a location which would constitute a 'place of business' for purposes of the 'fixed place of business' test.¹⁵⁷ Despite a web site not, of itself, constituting a permanent establishment a place where computer equipment is located, such as a server, may in certain circumstances constitute a permanent establishment.¹⁵⁸ To constitute a permanent establishment the functions performed should be of a significant level as well as an essential or core part of the business activity of the enterprise.¹⁵⁹ Profit attribution could therefore take place without any human intervention as this is no longer a requirement for the existence of a permanent establishment.¹⁶⁰ An example of a web site that would, under the OECD *Model Tax Convention on*

¹⁵⁵ Organisation for Economic Co-operation and Development Committee on Fiscal Affairs 2000 <http://www.oecd.org/dataoecd/46/32/1923380.pdf> at paragraph 06. See further Saunders et al *The Principles of International Tax Planning* 230.

¹⁵⁶ Inserted paragraph 42.2 of Article 5 of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*. See Organisation for Economic Co-operation and Development Committee on Fiscal Affairs 2000 <http://www.oecd.org/dataoecd/46/32/1923380.pdf> See further de Boynes 2002 *Global Jurist Frontiers* 13; McLure 2002 http://www.law.wayne.edu/mcintyre/text/mclure_EU-e-comm.pdf

¹⁵⁷ Inserted paragraph 42.2 of Article 5 of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*. See Organisation for Economic Co-operation and Development Committee on Fiscal Affairs 2000 <http://www.oecd.org/dataoecd/46/32/1923380.pdf> See further McLure 2002 http://www.law.wayne.edu/mcintyre/text/mclure_EU-e-comm.pdf

¹⁵⁸ Inserted paragraph 42.2 of Article 5 of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*. See Organisation for Economic Co-operation and Development Committee on Fiscal Affairs 2000 <http://www.oecd.org/dataoecd/46/32/1923380.pdf>

¹⁵⁹ Inserted paragraph 42.8 of Article 5 of the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*. See Organisation for Economic Co-operation and Development Committee on Fiscal Affairs 2000 <http://www.oecd.org/dataoecd/46/32/1923380.pdf> See further de Boynes 2002 *Global Jurist Frontiers* 14.

¹⁶⁰ Organisation for Economic Co-operation and Development Committee on Fiscal Affairs 2000 <http://www.oecd.org/dataoecd/46/32/1923380.pdf> at paragraph 9. See further McLure 2002 http://www.law.wayne.edu/mcintyre/text/mclure_EU-e-comm.pdf

Income and on Capital, 1977, constitute a permanent establishment is given by Cockfield as being one where:

...a server that is owned or leased by a non-resident company and displays a commercial web site which, in turn, advertises goods, takes orders and transmits information goods to the end consumer...¹⁶¹

Problematically, the OECD's new interpretation of a permanent establishment may allow advantages to those who migrate income to low or nil-tax jurisdictions when exploiting the fact that a server may no longer have a geographical connection with its income-producing activities. The new interpretation will not, generally, allocate tax jurisdiction and revenues to the location where production or consumption takes place. By-passing both the fiscal residence or fiscal source states would therefore occur and create new problems such as:

1. the server/permanent establishment not effectively allocating tax jurisdiction and revenue to fiscal source states, and
2. the server/permanent establishment creating tax planning opportunities that may enable multinational companies to shift tax jurisdictions and revenues away from fiscal residence states.¹⁶²

By-passing the fiscal residence or fiscal source states would amount to what in Admiralty law is termed, "flag-shopping". In much the same way as a ship traverses a territory that is not subject to any one state's jurisdiction (the "high seas") a similar paradigm shift is offered by the Internet. A "flag of convenience" can be flown by ships, which have little real connection with that particular, state for the legal and tax advantages it offers; so too might a server be fixed in a fiscal jurisdiction of convenience for the legal and tax advantages that it may offer.

¹⁶¹ Cockfield 2002 *Bulletin for International Fiscal Documentation* 608.

¹⁶² Cockfield 2002 *Bulletin for International Fiscal Documentation* 609.

6 Dénouement

6.1 Introduction

William Edward Simon is quoted as saying that “the nation should have a tax system that looks like someone designed it on purpose”.¹⁶³ Providing such a purposefully designed tax system is no easy feat, especially when it comes to electronic commerce. Any system presented or suggestions made will, of course, lead to pitfalls and problems. Although technological advances are relentless challenges that now face the taxation systems of this world, they remain only the latest in a long line of challenges that have faced it. It has been said of the Internet:

...[o]ur generation stands on the very cusp of the greatest technological revolution that mankind has ever faced. Some compare this age of electronic communication with the arrival of the Gutenberg press, or with the industrial revolution. This revolution, when it has run its course, may have a greater impact on the planet than anything that has preceded. The applications of electronic transmissions are just beginning to be felt [...] and the breadth and depth of what lies ahead is only beginning to be fathomed. How and where we are educated, where and how we work and live, our health care systems, our shops, our commerce, our reading, our leisure [...] no part of human enterprise will be spared even our notions of sovereignty and governance could be profoundly affected.¹⁶⁴

This profound statement leaves the reader with nothing less than an equally profound paradigm shift in perspective of the magnitude that will be the greatest technological revolution that mankind has ever faced. Electronic commerce is a growing part of that revolution and presents the taxation systems of this world with as much to ponder as those who were faced with pondering the possible means by which to tax the trade from the silk roads of China. In much the same way that the silk road of China presented legal and taxation challenges in those

¹⁶³ William Edward Simon (November 27, 1927 – June 3, 2000) was the sixty-third Secretary of the Treasury of the United States of America.

¹⁶⁴ Davis 2002 *Acta Juridica* 161 citing Johnston *Preface to Electronic Commerce – Opportunities and Challenges for Government*, 1977.

times so does its contemporary version present legal and taxation challenges in these times.

6.2 Findings of this study

The identification of fiscal jurisdiction was the focus of this study. In doing so, a study was made of the two central principles by which fiscal jurisdiction is made operational, namely the principles of source and residence based taxation as they are applied to electronic commerce. This study was undertaken to determine what the most appropriate method would be for South Africa to levy taxation on electronic commerce transactions, either by the principle of source or by the principle of residence based taxation or neither or both.¹⁶⁵ The findings of this study have revealed the following:

1. That in respect of electronic commerce transactions where South Africa is the purchasing party, the application of the principle of source based taxation finds the originating cause of the transaction to be the origin of the activity that generated that income. Such origin would not be within the fiscal jurisdiction of South Africa if no wit, labour or skill were employed within South Africa. Consequently, electronic commerce transactions where South Africa is the purchasing party cannot be taxed as they lack their origin, or income generating activity, within South Africa.¹⁶⁶
2. That in respect of electronic commerce transactions where South Africa is the purchasing party, a web site is not, of itself, a permanent establishment within South Africa. A server located within South Africa could however, after due consideration of various requirements, provide a sufficient *nexus* to allocate fiscal jurisdiction.
3. That in respect of electronic commerce transactions where South Africa is the selling party, the application of the principle of residence based taxation

¹⁶⁵ A proper study of transfer pricing, controlled foreign company legislation or other such disciplines may result in an alternative solution. Due to the scope of this study, these disciplines were not discussed however it is noted that they should be considered and balanced with the findings presented by this study.

¹⁶⁶ In the premise that no server is located within the fiscal jurisdiction of South Africa.

can be manipulated. Further, the effectiveness of the 'place of effective management' test becomes doubtful when faced with the technological advantages of the Internet when dealing with multiple locations over which the management functions are implemented. An alternative tie breaker test along the lines of the tie breaker test for individuals may need to be instituted to determine the fiscal jurisdiction of juristic persons engaged in electronic commerce to avoid manipulation. Such an alternative would address the strongest economic nexus of the juristic person engaged in electronic commerce transactions and consider where its centre of vital interest are, much in the same way as individuals are assessed.

The increased mobility of financial and intellectual capital, sophistication in legal transactions, institutions and business practices, and technological improvements in the transportation of people, things and information has lead to more questions than answers regarding taxation.¹⁶⁷ It can therefore be said that if ever a balance existed between the principle of source and the principle of residence, such has been upset by the advent of electronic commerce.¹⁶⁸ As this study has focused on the foundational aspects of fiscal jurisdiction for electronic commerce transaction in South Africa any of the recommendations made should assist in the foundational elements that could be continued upon. It is however important when doing so to consider the following criteria provided by the OECD as guidelines for an efficient and equitable taxation of electronic commerce:

1. The system should be equitable;
2. The system should be simple;
3. The rules should provide certainty;
4. Any system adopted should be effective;
5. Economic distortions should be avoided;
6. The system should be sufficiently flexible and dynamic; and

¹⁶⁷ Couzin *Corporate Residence and International Taxation* 05.

¹⁶⁸ Couzin *Corporate Residence and International Taxation* 05.

7. Any tax arrangement adopted domestically and any changes to existing international taxation principles should be structured to ensure a fair sharing of the Internet tax base between countries, particularly important as regards division of the tax base between developed and developing countries.¹⁶⁹

These guidelines should be utilised when developing a proper framework for electronic commerce in South Africa, such framework which is sorely lacking at present. The framework in turn should influence the negotiation of all Double Taxation Agreements between South Africa and its reciprocal contracting states. The foundations of which should be rooted in the development and clarification of the principle of residence based taxation. Any development and clarification would however greatly benefit from doing so with the 'place of effective management' to provide greater understanding in situations where the 'strongest economic nexus' test needs to be implemented.

¹⁶⁹ Owens 1997 <http://193.51.65.78/publications/observer/208/016-019a.pdf>

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