

An evaluation of the practical application of the South African VAT legislation on electronic services: A case study

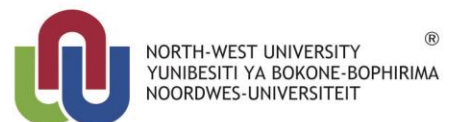
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degree Magister Commercii in South African and International Taxation at
the Potchefstroom Campus of the of the North-West University

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November 2015

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DECLARATION

I, Tsogo Rooi, hereby declare that this mini-dissertation, An evaluation of the practical application of the South African VAT legislation on electronic services: A case study, which I herewith submit to the North-West University Potchefstroom Campus, in compliance with the requirements set for the Master's degree, is my own work and has not already been submitted to any other university.



Signature: _____

Date: 13 November 2015

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Ultimately none of this would have been possible had it not been for the grace of God and his presence in my life. He continues to touch my life in the most amazing ways and I know I can do all things through Him.

ABSTRACT

TITLE: An evaluation of the practical application of the South African VAT legislation on electronic services: Case Study

KEYWORDS: E-COMMERCE, ELECTRONIC SERVICES, VALUE ADDED TAX

Electronic commerce (e-commerce) is a concept that started being a feature in business in the early 1970s (Wigand, 1997). Numerous businesses now conduct their business online. There have been repercussions arising from this craze as regulators have had to now attempt to regulate this new industry and this has posed significant challenges for tax authorities.

National Treasury issued draft regulations in January 2014 that define “electronic services”. These regulations are known as the Electronic Services Regulations (the Regulations) and details which digital products and services will be subject to the 14% VAT when the Regulations were to come into operation on 1 April 2014 (Department of National Treasury, 2014). The effective date was later moved to 1 June 2014 (Department of National Treasury, 2014).

The main objective of this dissertation was to explore an aspect of this new definition of electronic services through the presentation of a real life case study. Apple iTunes was profiled and the current VAT legislation was applied to this business. The case study details the transaction and maps out how the current VAT legislation will be applied to this transaction.

The research question was whether the current South African VAT legislation was applicable to a real-life transaction of the supply of electronic services of a non-resident, Apple iTunes, taking place in South Africa, would it be found to be practical, effective and efficient?

The following challenges affecting the practical application of the legislation were identified:

- Determination of the extent of the e-commerce transactions that Apple undertakes with customers online;
- The lack of documentation in e-commerce transactions and the inability to ensure validity of the information provided;
- The fact that there is no centralised tax administration framework;
- Exemption for imports of low valued goods or services;
- The low VAT threshold and the registration of FESES;
- The burden of compliance created on the FESES as a result of new legislation on e-commerce transactions;
- Enforcement of the tax legislation on e-commerce transactions; and
- Determination of the place of consumption.

Based on the challenges identified it was concluded that the current South African VAT legislation in its current form when applied to a real life transaction of the supply of electronic services of a non-resident, Apple iTunes, taking place in South Africa, would be found:

- Not to be practical as SARS would have significant difficulty determining the extent of activities for B2C transactions and SARS would encounter challenges in enforcing the tax legislation on e-commerce transactions as the accuracy of the documentation provided by customers may be questionable.
- To be ineffective as the VAT legislation on e-commerce transactions would not be successful in achieving the desired result if it cannot be enforced.
- To be inefficient if it continues to create an administrative burden of compliance on the Foreign Suppliers of Electronic Services where the costs outweigh the benefits.

The challenges noted in this dissertation are identified. There is no simple resolution to the issues identified as international tax authorities are battling to identify ways to overcome the above-mentioned challenges.

Table of Contents

DECLARATION	i
ACKNOWLEDGEMENTS.....	ii
ABSTRACT.....	iii
ABBREVIATIONS.....	viii
CHAPTER 1: INTRODUCTION, BACKGROUND, RESEARCH QUESTION & OBJECTIVES, RESEARCH METHODOLOGY	1
1.1 INTRODUCTION.....	1
1.1.1 BACKGROUND TO THE STUDY.....	1
1.1.2 MOTIVATION OF THE TOPICALITY OF THE STUDY.....	3
1.2 LIMITATIONS.....	5
1.3 RESEARCH QUESTION	5
1.4 OBJECTIVES	6
1.4.1 MAIN OBJECTIVE	6
1.4.2 SECONDARY OBJECTIVES.....	6
1.5 RESEARCH DESIGN/METHOD.....	7
1.5.1 ONTOLOGY.....	7
1.5.2 RESEARCH PARADIGM.....	7
1.5.3 RESEARCH METHODOLOGY.....	7
1.5.4 APPROACH FOLLOWED TO ANSWER THE RESEARCH QUESTION	8
1.5.5 RESEARCH METHOD APPLIED	8
1.6 ETHICAL CONSIDERATIONS.....	9
1.7 OVERVIEW	11
CHAPTER 2: TAXATION OF ELECTRONIC SERVICES TRANSACTIONS IN SOUTH AFRICA....	14
2.1 INTRODUCTION.....	14
2.2 THE ROLE OF THE NATIONAL TREASURY AND THE SOUTH AFRICAN REVENUE SERVICE	14
2.3 PERMANENT ESTABLISHMENT	14
2.4 OUTLINE OF THE VAT SYSTEM	16
2.4.1 INPUT AND OUTPUT TAX.....	17
2.4.2 STANDARD RATED SUPPLIES, ZERO RATED SUPPLIES AND EXEMPT SUPPLIES .	18
2.5 THE IMPOSITION OF VAT	18
2.5.1 SUPPLY	19
2.5.2 VENDOR.....	19
2.5.3 GOODS.....	19
2.5.4 SERVICES.....	20
2.5.5 ENTERPRISE	20
2.6 DEFINITIONS OF ELECTRONIC SERVICES (E-COMMERCE) IN SOUTH AFRICA.....	22
2.6.1 PREVIOUS DEFINITIONS APPLIED	22

2.6.2	CURRENT DEFINITION OF E-COMMERCE SERVICES.....	23
2.6.3	THE REGULATION	24
2.7	REGISTRATION FOR VAT AND VAT THRESHOLD	25
2.8	INTERNATIONAL GUIDELINES ON APPLYING INDIRECT TAXES ON E- COMMERCE TRANSACTIONS	27
2.8.1	THE OECD.....	28
2.8.2	THE EUROPEAN UNION (EU).....	29
2.8.3	PRINCIPLES OF A GOOD TAX SYSTEM	30
2.8.3.1	NEUTRALITY.....	31
2.8.3.2	EFFICIENCY	31
2.8.3.3	CERTAINTY.....	32
2.8.3.4	SIMPLICITY	32
2.8.3.5	EFFECTIVENESS AND FAIRNESS.....	33
2.8.3.6	FLEXIBILITY	33
2.8.4	CATEGORIES OF E-COMMERCE TRANSACTIONS	33
2.8.4.1	SUPPLY OF E-COMMERCE GOODS TO BUSINESS AND PRIVATE CONSUMERS	33
2.8.4.2	SUPPLY OF E-COMMERCE GOODS AND SERVICES FROM BUSINESS TO BUSINESS	34
2.8.4.3	SUPPLY OF E-COMMERCE GOODS AND SERVICES FROM BUSINESS TO CONSUMER (B2C)	35
2.8.5.1	OECD DEFINITION OF E-COMMERCE	36
2.8.5.2	OTHER GENERAL DEFINITIONS:	37
2.8.5.3	EUROPEAN DEFINITION OF E-COMMERCE	37
2.8.5.3.1	DIRECTIVE 2002/38/EC OF 7 MAY 2007	37
2.9	RELEVANCE OF CONSUMPTION TAXES	38
2.10	CONCLUSION	39
	CHAPTER 3: SELECTION OF THE SERVICE PER THE REGULATION AND DESCRIPTION OF THE APPLE iTUNES SERVICE PROVIDED TO CUSTOMERS.....	40
3.1.	INTRODUCTION.....	40
3.2.	SELECTION OF THE ELECTRONIC SERVICE FROM THE REGULATION.....	40
3.3.	LIMITATION OF THE STUDY	41
3.4.	SELECTION OF THE SUBJECT OF THE CASE STUDY	41
3.5.	HOW MANY iTUNES USERS ARE THERE?.....	42
3.6.	HOW DOES iTUNES WORK?.....	43
3.7.	THE APPLE ID.....	44
3.8.	CONCLUSION	44
	CHAPTER 4: APPLICATION OF THE SA VAT LEGISLATION TO ELECTRONIC SERVICES THAT APPLE iTUNES PROVIDES TO CUSTOMERS IN SOUTH AFRICA.....	46
4.1	INTRODUCTION	46
4.2	BACKGROUND FACTS.....	46
4.3	APPLICATION OF THE SOUTH AFRICAN VAT LEGISLATION ON THE TRANSACTION	48

4.3.1	IS THERE A SUPPLY?.....	49
4.3.2	IS IT A SUPPLY OF GOODS OR SERVICES?.....	49
4.3.3	WAS A SUPPLY MADE BY A VENDOR?	49
4.3.4	IS THE VENDOR CARRYING ON AN ENTERPRISE OR WHERE IS THE SUPPLY MADE?	51
4.3.5	VALUE OF SUPPLY	52
4.4	CHALLENGES IDENTIFIED.....	53
4.5	CONCLUSION.....	55
CHAPTER 5: CONSIDERATION OF THE DEFICIENCIES NOTED IN THE APPLICATION OF THE LEGISLATION		56
5.1	INTRODUCTION.....	56
5.1.1	DEFICIENCIES OR CONCERNS IDENTIFIED.....	57
5.1.2	DETERMINATION OF THE EXTENT OF ACTIVITIES.....	57
5.1.3	DOCUMENTATION	58
5.1.4	CENTRALISED TAX ADMINISTRATION FRAMEWORK.....	59
5.1.5	EXEMPTION FOR IMPORTS OF LOW VALUED GOODS OR SERVICES.....	60
5.1.6	VAT THRESHOLD AND REGISTRATION	62
5.1.7	BURDEN OF COMPLIANCE	63
5.1.8	ENFORCEMENT OF TAX LAWS.....	64
5.1.9	PLACE OF CONSUMPTION AND IDENTIFICATION OF CUSTOMERS.....	66
5.2	PRINCIPLES OF A GOOD TAX SYSTEM	69
5.3	CONCLUSION	70
CHAPTER 6: SUMMARY, CONCLUSION AND RECOMMENDATIONS.....		73
6.1	INTRODUCTION.....	73
6.2	BACKGROUND OF RESEARCH	73
6.3.	LIMITATIONS OF THE STUDY	74
6.4.1	FIRST SECONDARY OBJECTIVE.....	74
6.4.2	SECOND SECONDARY OBJECTIVE.....	75
6.4.3	THIRD SECONDARY OBJECTIVE	76
6.4.4	FOURTH SECONDARY OBJECTIVE	76
6.5.	OPPORTUNITIES FOR FURTHER STUDY	77
6.6	CONCLUSION AND RECOMMENDATIONS.....	77

ABBREVIATIONS

Apple	Apple Inc.
BEPS	Base Erosion and Profit Shifting
E-commerce	Electronic commerce
E-services	Electronic services
EU	European Union
FESEs	Foreign Suppliers of Electronic Services
OECD	Organization for Economic Co-operation and Development
POEM	Place of effective management
VAT	Value Added Tax
VAT Act	Value-Added Tax Act (89 of 1991)
SARS	South African Revenue Service
The Regulations	The Electronic Services Regulations - Regulations prescribing electronic services for the purpose of the definition of “electronic services” in Section 1(1) of the Value-Added Tax Act (89 of 1991)
USA	United States of America

CHAPTER 1: INTRODUCTION, BACKGROUND, RESEARCH QUESTION & OBJECTIVES, RESEARCH METHODOLOGY

1.1 INTRODUCTION

1.1.1 BACKGROUND TO THE STUDY

In the 1960s the USA defence department developed a computer network known as the APRANET. In the early 1980's the network was expanded and a web now known as the internet emerged (Gelman,1998:1-3). In June 2012 it was estimated that more than two billion people were using the internet (Internet world statistics, 2012). According to Monsuwé, Benedict and Dellaert (2004) the relative ease of accessing the internet and the convenience that comes with the medium has resulted in a significant number of consumers purchasing goods and services online. This has sparked a billion-dollar industry for companies that sold their goods and services on the internet.

Electronic commerce (e-commerce) is a concept that started being a feature in business in the early 1970s (Wigand, 1997). According to the Organization for Economic Co-operation and Development (OECD) (2011) an e-commerce transaction is “the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or services do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organisations. To be included are orders made over the web, extranet or electronic data interchange. The type is defined by the method of placing the order. To be excluded are orders made by telephone calls, facsimile or manually typed e-mail”.

The *Oxford South African Secondary School Dictionary of Current English* (2005:194) defines e-commerce as “commerce and business conducted electronically on the Internet”. The *Merriam Webster* (2014) dictionary defines online as “connected to, served by, or available through a system and especially a computer or telecommunications system (as the Internet). E-commerce thus provides a new dimension to how traditional business transactions occur. It has taken the global

business world and made it smaller thus effectively increasing competition (OECD, 2001b:9).

Numerous businesses now conduct their business online. For example, Amazon.com's worldwide sales of tangibles, intangibles, and services were USD34 billion in 2010. Global clicks at Google.com contributed USD10.5 billion revenues in its fourth quarter, for the 2011 fiscal year. It was estimated that 97 million buyers and sellers that met on eBay.com had spent a total of USD62billion in 2010. Americans spent over USD173 billion on online shopping and the expected global turnover is said to increase to USD963 billion in 2013 (Azam, 2012).

Apple Inc. (Apple) is a company that was founded by Steve Jobs, Steve Wozniak and Ronald Wayne on 1 April 1976 in California, United States of America. It was then named Apple Computer Inc. The company is said to have revolutionized the computer and cell phone market and the way we communicate. Apple has launched successful products in its 38-year history namely iMac, iPod, iPhone, and iPad. The success that Apple has experienced is unprecedented and the company is currently at the forefront of innovation (Lusensky, 2014).

Apple launched the iTunes music store on 28 April 2003. This is a revolutionary music download store which was initially priced at USD0.99 per song. Apple iStore allows customers to search their online catalogue and download music amongst other products at a click of a button (Apple, 2003).

According to the *PC Magazine Encyclopaedia* (2014) iTunes is an "popular media player software from Apple for Mac and Windows". iTunes is used by millions of people to gather and download music, movies, videos and applications on their iPads, iPhones and iPods from Apple's online store (PC Magazine Encyclopaedia, 2014).

According to Apple, iStore is "the world's No.1 music store". It hosts "millions of songs, thousands of films to buy or rent, hundreds of thousands of apps and podcasts" (Apple, 2014a).

According to France (2008) who writes for Tech Culture, Apple is number one in a poll of top five online music stores. Apple announced on 4 December 2012 that the

company would be launching their iTunes store in South Africa at about R6.99 per track. Album prices differ (McLeod, 2013). At that time it would have been available in 119 countries and could be accessed by customers using their Apple devices (Apple, 2012). Apple announced in February 2013 that it had set a new record and the iStore had sold 25 billion songs. It was said to be the world's most popular music store (Apple, 2013). Apple reported in January 2014 that over USD10 billion worth of sales were reported in 2013 from their app stores (Apple, 2014b).

According to the *Online Dictionary* (2014) an app is “a self-contained program or piece of software designed to fulfil a particular purpose; an application, especially as downloaded by a user to a mobile device”.

1.1.2 MOTIVATION OF THE TOPICALITY OF THE STUDY

The statistics attest to the popularity of iTunes worldwide and now also in South Africa. A pertinent question flowing from this is what part of Apple's revenue is actually subject to any form of taxation?

There have been repercussions arising from this craze as regulators have had to now attempt to regulate this new industry and this has posed significant challenges. In the area of taxation specifically, questions had to be raised on (OECD, 2001a):

- Which jurisdiction(s) are to tax these companies?
- How to determine the place of effective management (POEM)?
- Whether traditional corporate tax rules could apply to e-commerce tax transactions?
- How to apply Value Added Tax (VAT) rules?
- Where would the place of consumption of these services be?

On the one hand the companies that do their business online have managed to grow exponentially (Jones, 2013), on the other hand they have enjoyed a competitive advantage over local companies that have to pay taxes (Bardopoulos, 2013). A further disadvantage to the status quo has been that the tax authorities have not been able to realise their fair share of taxes on this business taking place in the respective countries (High Street Partners, 2013).

This is an area that authorities can no longer ignore due to the massive impact it now has on the global economy. This issue has been investigated by the international community resulting in the OECD, the European Union (EU) and many other international bodies issuing publications on the topic and adjusting their laws and regulations to encompass e-commerce transactions.

South Africa has joined many countries like Australia, New Zealand, Canada, Japan (OECD, 2001) and China (Zhang, Lu & KuAug, 2013), in tackling the taxation of e-commerce transactions. It might be the realisation that there had been a significant loss of income that has resulted from the lack of taxation of electronic services rendered by non-residents that are not subject to tax locally, however this is a welcome move by the National Treasury as it seeks to broaden the South African tax revenue base. This is, however, not without its challenges. In the Budget Speech (2013) the finance minister at that time, Pravin Gordhan, proposed that foreign businesses who “sell e-books, music and other digital goods and services” be required to register for VAT (Department of National Treasury, 2013b).

National Treasury issued draft regulations in January 2014 that define “electronic services”. These regulations are known as the Electronic Services Regulations (the Regulations) and they detail which digital products and services will be subject to the 14% VAT when the Regulations were to come into operation on 1 April 2014 (Department of National Treasury, 2014). The effective date was later moved to 1 June 2014 (Department of National Treasury, 2014).

The concept of taxation of electronic services is fairly new in South Africa. In the local legislation there are currently no published rulings, relevant publications or interpretation notes focusing on the VAT treatment of e-commerce in South Africa (Naicker, 2010). There is limited case law and there are few interpretations provided on e-commerce services in South Africa (Bardopoulos, 2012:178). There is thus great uncertainty on the application of the South African legislation on electronic services. This creates a significant gap in knowledge as there is little understanding of how e-services transactions will practically be affected by the new legislation.

The main objective of this dissertation is thus to explore an aspect of this new definition of electronic services through the presentation of a real-life case study. An existing

non-resident business will be profiled and the current VAT legislation will be applied to this business. This case study will detail the transaction and map out how the current VAT legislation could possibly be applied to this transaction.

1.2 LIMITATIONS

The Regulations prescribing electronic services for the purpose of the definition of “electronic services” in Section 1(1) of the Value-Added Tax Act (89 of 1991) (VAT Act) defines electronic services and lists items that fall within the definition. This dissertation intends only to address one aspect of the definition mentioned in the Regulations and will specifically exclude the other items listed. The sales of Apple iTunes will be the main focus of the case study; however, there are many aspects of this new regulation that may be applied to a wide range of transactions. For the purpose of this dissertation only the Business to Consumer (“B2C”) model will be considered in par. 2.8.4. B2C has been selected due to the complex nature and challenges that arise in relation to e-commerce tax.

For the purposes of this study, only regulation 6 dealing with miscellaneous services will be considered which lists the supply of e-books, film, music, images and software. E-books include electronic publications. Films include movies, video clips etc. Music includes audioclips, songs and jingles. Images include photographic material etc. (South Africa, 2014:5:6).

1.3 RESEARCH QUESTION

If the current South African VAT legislation is applied to a real life transaction of the supply of electronic services of a non-resident, Apple iTunes, taking place in South Africa, would it be found to be practical, effective and efficient?

The *Oxford Dictionary* (2015) defines the word *practical* as “of or concerned with the actual doing or use of something rather than with theory and ideas” and “suitable for a particular purpose”. The question arises whether or not the theory contained in the legislation is suitable for a purpose or if it remains a theory or idea.

The *Oxford Dictionary* (2015) defines the word *effective* as “successful in producing a desired or intended result”. The research question will be answered by determining

whether the VAT legislation on e-commerce transactions will be successful in producing the desired result.

The *Oxford Dictionary* (2015) defines the word *efficient* as “achieving maximum productivity with minimum wasted effort or expense”. The OECD (2014) states that “in order to ensure efficiency it is important that the administrative burden that tax rules impose on taxpayers and administrations should be minimised as far as possible”.

1.4 OBJECTIVES

1.4.1 MAIN OBJECTIVE

The main objective of this study will be to ascertain whether the current VAT provisions are effective and efficient to be successfully and practically implemented in terms of electronic services supplied by a non-resident in South Africa. This main objective will be addressed by the following four secondary objectives:

1.4.2 SECONDARY OBJECTIVES

- i. The first secondary objective is to consider South Africa’s current VAT structure regarding transactions of electronic services. An evaluation of the legislation and possible deficiencies noted in the practical, effective and efficient application thereof will be discussed. Furthermore, brief reference will be made to international guidelines on indirect taxes of electronic services. This objective will be addressed in Chapter 2.
- ii. The second secondary objective of this study is to identify a specific electronic service transaction to which the definition, as defined by the Regulations prescribing electronic services for the purpose of the definition of “electronic services”, will be applicable. A description of the selected service provided to customers in South Africa by the non-resident, Apple iTunes, will be done. This objective will be addressed in Chapter 3.
- iii. The third secondary objective is to use a case study as an explanatory tool; a business transaction will be profiled. The VAT legislation shall be applied to the transaction and each aspect of how it will be applied to the scenario

shall be discussed. The practicality, effectiveness and efficiency will be evaluated. This objective will be addressed in Chapter 4.

- iv. The fourth secondary objective is to consider the challenges of the e-commerce environment and the deficiencies noted in the South African implementation of e-commerce legislation regarding the practicality, effectiveness and efficiency of the system. South Africa is not the first country to legislate the taxation of e-commerce services, where applicable references will be made to the OECD and the challenges noted at an international level that will further substantiate the arguments made in this dissertation. This objective will be addressed in Chapter 5
- v. The fifth secondary objective is to summarise and conclude on the findings of the study with regards to the practicality, effectiveness and efficiency of the South African VAT on e-commerce services and to provide recommendations to the South African Revenue Service (“SARS”) based on the findings of the study. This objective is addressed in Chapter 6.

1.5 RESEARCH DESIGN/METHOD

1.5.1 ONTOLOGY

The ontology in this dissertation will be of a relativist view of the world and knowledge (Coetzee, Van der Zwan & Schutte, 2014).

1.5.2 RESEARCH PARADIGM

The research for the dissertation will be conducted in the interpretivist paradigm. It will be aimed at gaining a better understanding of the effectiveness of the VAT legislation on e-commerce transactions namely Apple iTunes. The aim is to prove a single point and to obtain a better understanding of the treatment of e-commerce transactions (Coetzee *et al.*, 2014).

1.5.3 RESEARCH METHODOLOGY

The critical theory/critical analysis methodology will be applied. The dissertation will critique and challenge some principles in the VAT legislation by using the literature available on the topic (Coetzee *et al.*, 2014).

1.5.4 APPROACH FOLLOWED TO ANSWER THE RESEARCH QUESTION

The research will follow an inductive reasoning approach (Mouton, 2001:118). The supply of music (sample) will be selected from the definition of electronic services (population) and a strong argument based on the evidence obtained will be formulated which will support the conclusion reached. This approach is the most appropriate as the dissertation will start with observations and then specific situations will be used to reach the conclusion (Mouton, 2001:118).

1.5.5 RESEARCH METHOD APPLIED

This dissertation will be in the form of a case study.

What is a case study?

A case study is an empirical inquiry that investigates a contemporary phenomenon (the 'case') in depth within its real-life context, especially when the boundaries between phenomenon and context are not clearly evident". A case study deals with a specific situation which combines multiple sources of evidence and brings the sources together in a "triangulation fashion". It is thus an "all-encompassing" method (Yin, 2014:16-17).

From the above definition a case study is thus research on existing "phenomena" to create an in-depth analysis of the selected subject matter and is achieved by combining various data-collection methods.

The case study method in this dissertation will be used as an explanatory tool and will be carefully planned and crafted to reveal a real-life situation and it will highlight the issues and problems that will be faced in the implementation of the VAT legislation on electronic services.

The design and completion of a case study in order to answer the research question requires a significant analysis of literature and understanding of the subject matter (Darke, Shanks & Broadbent, 1998).

A detailed literature review will be conducted guided by the objectives of the study. The following sources will be consulted:

- National Treasury Explanatory memorandum of the taxation laws amendment Bill, 2013
- National Treasury Regulation prescribing Electronic Services for the purpose of the definition of “Electronic Services” in Section 1(1) of the Value-added tax Act, 1991
- Value-added Tax Act (89 of 1991)
- LAPD-VAT-G02 - VAT 404 Guide for Vendors - External Guide
- Deloitte VAT, Handbook Last Updated: 9th ed 2013
- Magazines, websites of professional accounting and taxation bodies
- Foreign case law
- OECD publications
- Scientific articles in published journals

One aspect of the definition of electronic services will be discussed, thus providing for an in-depth investigation and discussion. The case data will be collected and collated and maintained throughout the process.

A common criticism that comes up when a case study methodology is applied is generalisation. The use of many sources will further substantiate the validity of the outcome of the study (Darke *et al.*, 1998).

1.6 ETHICAL CONSIDERATIONS

A variety of sources will be reviewed in order to ensure the reliability of information used in this study. The main basis of arguments contained in the dissertation will be from the legislation. Credible sources such as expert opinions, peer reviewed articles and journals will be used.

The most significant ethical consideration in the compilation of this dissertation will be possible plagiarism, as a literature survey will be the main source of the data used. This risk will be mitigated through the referencing and mentioning of authors' work that has been used, paraphrasing and quoting where necessary. The dissertation will be

compiled from the authors' interpretation of the legislation; however, various views will be investigated to prevent bias.

1.7 OVERVIEW

CHAPTER 1

INTRODUCTION, BACKGROUND, RESEARCH QUESTION & OBJECTIVES, RESEARCH METHODOLOGY

The purpose of this chapter is to introduce the research question and create context on the importance of the dissertation. It will unpack the meaningfulness of the proposed question and the background from which the research stems. The key terms in the research will be defined in this chapter.

The introduction will create an understanding of what methodology will be applied and the rationale for selecting the methodology. The chapter will highlight the potential outcomes of the study.

CHAPTER 2

TAXATION OF ELECTRONIC SERVICES TRANSACTIONS IN SOUTH AFRICA

The purpose of this chapter is to consider and interpret the South African VAT legal framework on e-commerce transactions provided by foreign companies in South Africa and provide insight on the practical, effective and efficient application of this legislation. International guidelines on indirect taxes on e-commerce or electronic services will also be briefly considered. The deficiencies noted will be identified. This will address the research objective as identified in par. 1.4.2(i).

CHAPTER 3

SELECTION OF THE SERVICE PER THE REGULATION AND DESCRIPTION OF APPLE iTUNES SERVICE PROVIDED TO CUSTOMERS

The purpose of this chapter is to outline the selection of the service that will be the focus of the case study from the Regulations prescribing electronic services for the purpose of the definition of “electronic services”. A description of the selected Apple iTunes service provided to the customers will be done. It will also note the limitations of the study. This will address the research objective as identified in par. 1.4.2(ii).

CHAPTER 4

APPLICATION OF THE LEGISLATION TO THE SERVICES THAT APPLE iTUNES PROVIDES TO CUSTOMERS

The purpose of this chapter is to perform a case study to understand how the South African VAT legislation on e-commerce could be applied to the electronic services rendered by Apple iTunes. This will look into how practical, effective and efficient the system is. The case study will outline the process of the transactions and the various considerations that must be made in applying the legislation. The deficiencies noted in the application of the case study will be discussed. This will address the research objective as identified in par. 1.4.2(iii).

CHAPTER 5

CONSIDERATION OF THE DEFICIENCIES NOTED IN THE APPLICATION OF THE LEGISLATION

The purpose of this chapter is to consider the deficiencies or challenges noted in chapters 2 to 4. Since South Africa is not the first country to legislate the taxation of e-commerce services, applicable references will be made to the OECD and European Union ("EU"), that will further substantiate the arguments made in this dissertation. This chapter will further consider how these international bodies have tackled the challenges identified. The deficiencies noted in this chapter will further assist in determining whether or not the VAT legislation is practical, effective and efficient. This will address the research objective as identified in par. 1.4.2(iv).

CHAPTER 6

SUMMARY, CONCLUSION, AND RECOMMENDATIONS

This chapter will summarise and make conclusions on the findings of the study. The conclusion will outline whether the application of electronic services (e-commerce transactions) legislation is practical, efficient and effective when applied to Apple iTunes transactions. Recommendations will be made to SARS, based on the results

of the study. This chapter will address the research objective as identified in par. 1.4.2(v).

CHAPTER 2: TAXATION OF ELECTRONIC SERVICES TRANSACTIONS IN SOUTH AFRICA

2.1 INTRODUCTION

In this chapter the interpretation of the South African VAT legal framework on e-commerce transactions provided by foreign companies in South Africa, with a focus on the practicality, effectiveness and efficiency of the system and provide insight into the application of this legislation will be considered. International guidelines on indirect taxes on e-commerce or electronic services will also be briefly considered. This will address the research objective as identified in par 1.4.2(i). In order to perform an analysis of the legislation it is imperative that the VAT concepts are defined.

2.2 THE ROLE OF THE NATIONAL TREASURY AND THE SOUTH AFRICAN REVENUE SERVICE

The National Treasury is responsible for the management of South Africa's finances and the allocation of the South African budget. It is governed by the Public Finance Management Act 1 of 1999 (National Treasury, 2015). In terms of the South African Revenue Service Act (34 of 1997) SARS is responsible for the collection of taxes and ensuring compliance amongst taxpayers. SARS is an independent organ of the state. The South African tax regime is decided on by the National Treasury and SARS is responsible for the administration of taxes in South Africa. These two institutions play a significant role in both the collection and administration of tax in South Africa.

2.3 PERMANENT ESTABLISHMENT

In order to determine whether services rendered by a non-resident in South Africa would attract normal tax in terms of the gross income definition of the Income Tax Act (58 of 1962) one would need to consider the source rules, physical presence and permanent establishment (PE).

A PE is defined as a fixed place of business through which the business of an enterprise is wholly or partly carried on. The PE concept refers to substantial physical presence in the country where services are provided and where the non-resident

makes use of an agent in that country in order to conduct their business (OECD, 2013c).

In its first interim report the Davis Tax Committee (2014:30) held that South Africa had attempted to tackle the challenges created by the digital economy by introducing tax legislation which focuses on indirect taxes rather than direct taxes. VAT is an indirect tax.

With the digital economy the service providers operate remotely and provide their services via the internet thus making it increasingly difficult to determine the PE due to a lack of substantial physical presence (OECD, 2013a). Traditional income tax rules may no longer be effective for the digital economy (Pronina, 11:24).

Given the challenges that exist in determining the PE under direct taxes the use of indirect taxes has proven to be workable and seems to follow the approach adopted by the OECD.

In its first interim report the Davis Tax Committee (2014:31) held that in Spain a web presence may not result in a PE for direct tax purposes thus not resulting in direct tax for foreign suppliers but grounds for taxation under VAT laws may exist. Canadian authorities are less focused on the PE in their income tax rules but rather a tax on transaction which makes sense in an e-commerce environment.

The South African VAT legislation has been amended and now requires foreign suppliers of e-commerce to register for VAT in South Africa. This move came after it had been established that these suppliers failed the physical presence test and were considered as not having a PE in South Africa. In paragraph 3 of the article Key VAT issues stemming from the 2013 tax amendments it states that the situation was further aggravated by the fact that the reverse charge mechanism was proving to be ineffective in assisting the revenue authorities in collecting taxes. This left a gap in the revenue to be collected (KPMG, 2013:3).

South Africa has aligned itself with the global community by adhering to the OECD guidelines and defining digital goods as services for VAT purposes.

2.4 OUTLINE OF THE VAT SYSTEM

In order to understand whether electronic services should be subject to VAT it is important to understand how the South African VAT Act operates. The South African VAT system is characterised by consistent regulation by way of legislative enactments as its cornerstone.

South Africa previously had a General Sales Tax (GST) system which was implemented in 1978. This tax was initially introduced at a rate of 4% and it had a far lower range of goods and services that it taxed than VAT. VAT was introduced in September of 1991 (Silver & Beneke, 2013:3). VAT replaced GST and was initially levied at 10%. Both systems tax the consumer or end user (Go, Kearney, Robison & Thierfelder, 2005). VAT is an indirect tax (SARS, 2013). The significant difference between the two systems is that GST only taxed the sale to the final consumer (single stage tax) whereas VAT is levied on each transaction in the production and distribution chain (Silver & Beneke, 2013:3).

Some advantages of a VAT system:

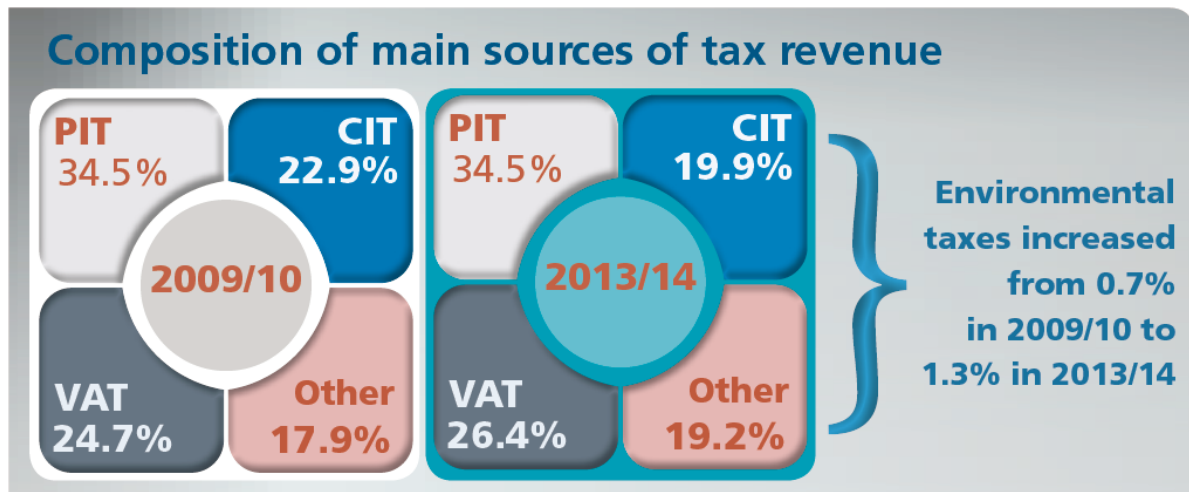
- VAT has more agents at every stage of production that are responsible for collecting taxes on behalf of the revenue authorities and provides a clearer audit trail;
- The VAT rate introduced under VAT was higher;
- The tax base under VAT is wider (Silver & Beneke, 2013:3-4).

Over the years the VAT rate has grown from 10% to 14% (Kearney, 2003). The standard rates of tax applied in South Africa are 14% and zero-rated taxes (Bardopoulos, 2012:178). Exports of goods and services are zero-rated supplies and do not attract VAT but import of services attracts VAT (Silver & Beneke, 2013).

VAT has evolved since its inception. The National Treasury reported that in the 2012/2013 financial year it had 650 540 registered VAT vendors of which 425 476 (64%) were active (National Treasury, 2013). In 2013/2014 there were 662 194 registered vendors and 420 785 active vendors. The total revenue collected from all taxes was R813.8 billion of which R215 billion related to VAT (National Treasury,

2013) and the total revenue collected in 2014 was R900 billion of which R237.7 billion related to VAT (National Treasury, 2014). When you put this into perspective 26.4 % (in both years) of the South African revenue base relates to VAT. One could conclude that it is imperative that the correct legislation be enacted in order to ensure the revenue base is not compromised in future.

Figure 2.1: Composition of South African main source of revenue 2013/2014



Source: National Treasury Tax Statistics, 2014

The basic concepts of a South African VAT system are as follows:

2.4.1 INPUT AND OUTPUT TAX

Input and output VAT are defined in section 1 of the VAT Act as follows:

“output tax, in relation to any vendor, means the tax charged under section 7 (1) (a) in respect of the supply of goods and services by that vendor.”

“input tax, in relation to a vendor, means—

(a) tax charged under section 7 and payable in terms of that section by—

- i) a supplier on the supply of goods or services made by that supplier to the vendor; or*
- ii) the vendor on the importation of goods by that vendor; or*

iii) the vendor under the provisions of section 7 (3)..."

Output tax is levied on a supply of goods and services made by a vendor (Silver & Beneke, 2013) and Input tax is the VAT payable on purchases of goods and services made by a vendor from another vendor in the course of making taxable supplies (SAICA, 2012). A vendor sets off input tax against the output tax in determining whether the vendor is in a VAT payable or refundable position (Silver & Beneke, 2013).

2.4.2 STANDARD RATED SUPPLIES, ZERO RATED SUPPLIES AND EXEMPT SUPPLIES

The goods and services that are subject to VAT are either standard rated, zero rated or exempt supplies (SAICA, 2012). Section 11 of the VAT Act deals with zero rated supplies and section 12 of the VAT Act deals with exempt supplies. Standard rated supplies are any supplies that are not zero rated or exempt supplies in terms of the VAT Act (Silver & Beneke, 2013). Standard rated supplies levy VAT at 14%. Section 12 of the VAT Act comprises a list of supplies of goods and services that are exempt from VAT, these are termed exempt supplies. As a result no VAT is levied on these supplies. Section 11 of the VAT Act comprises a list of supplies of goods and services that are zero rated, these are termed zero rated supplies. (Silver & Beneke, 2013). Zero rated supplies are taxable at a rate of 0% (SAICA, 2012). No output VAT is levied on zero rated supplies but a vendor may claim input VAT (Silver & Beneke, 2013). These terms are defined in section 1 of the VAT Act.

2.5 THE IMPOSITION OF VAT

Section 7(1) of the VAT Act deals with the imposition of VAT. VAT is calculated at a rate of 14% of the value of a supply once all the concepts below are met. In order for a transaction to attract VAT in terms of this section any one of the following requirements must be met:

- a) There must be a **supply by a vendor of goods or services** in the course or furtherance of any **enterprise** carried on; or
- b) When dealing with the **importation** of any **goods** by any person; or

- c) When dealing with the **supply** of any **imported services by any person** (VAT Act).

Electronic services could fall into either section 7(1)(a) or 7(1)(c). Both will be considered below.

The VAT levied in terms of Section 7(1) (a) requires that some aspects be present. These aspects will be explored very briefly in order to determine if e-commerce would comply with this section.

2.5.1 SUPPLY

The definition of “supply” in Section 1 of the VAT Act includes a sale, rental agreement, instalment credit agreement and all other forms of supply, whether voluntary, compulsory or by operation of law, irrespective of where the supply is effected. This definition in the VAT Act is a very broad definition of a supply and it is submitted that this definition would include the supply of e-commerce transactions.

2.5.2 VENDOR

In Section 1 of the Vat Act a “vendor” is defined as any person who is required to register for VAT in terms of the VAT Act.

Thus it could be concluded that supplies by a non-vendor would not attract VAT, unless it is an importation of goods or services in terms of Section 7(1)(b) or 7(1)(c) of the VAT Act.

Based on the definition above should Foreign Suppliers of Electronic Services (“FESEs) be required to register for VAT in terms of the VAT Act, the FESE would then be a vendor. It is thus important to determine whether a FESE would meet the VAT Act requirements for VAT registration.

2.5.3 GOODS

In Section 1 to the VAT Act goods is defined as “corporeal movable things, fixed property, any real right in any such thing or fixed property, and electricity, but excluding—

- (a) money;
- (b) any right under a mortgage bond or pledge of any such thing or fixed property; and
- (c) any stamp, form or card which has a money value and has been sold or issued by the State for the payment of any tax or duty levied under any Act of Parliament, except when subsequent to its original sale or issue it is disposed of or imported as a collector's piece or investment article."

As discussed in chapter 1, e-commerce services occur over the internet and it is thus not corporeal movable things. It is not fixed property or tangible either. It is highly unlikely that it would fall within the definition of goods.

2.5.4 SERVICES

The VAT Act defines "services" as anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, form or card contemplated in paragraph (c) of the definition of "goods".

The definition of services would have to be reviewed against the characteristics of electronic services to determine whether electronic services fall within the above definition.

According to De Swardt and Oberholzer (cited by Mahlunge, 2014:36), due to the fact that e-commerce relates to intangible items that are not fixed property and cannot be physically touched it would not qualify as goods but would rather be classified as services.

2.5.5 ENTERPRISE

The VAT Act further provides in Section 7(1)(a) that in order for a transaction to attract VAT it must be in the "course of furtherance of any enterprise" (Deloitte, 2013).

The definition of an enterprise was previously a contentious issue and thus it has been revised. The previous definition stated that enterprise is "an activity which is carried

on continuously or regularly by any person in the Republic or partly in the Republic” (VAT Act). The last element of the definition “in the Republic or partly in the Republic” clearly excludes the transactions outside the Republic and therefore possibly e-commerce transactions, depending on where the transaction is deemed to have taken place.

The Tax Laws Amendment Act (31 of 2013) introduced an amendment to the definition of an enterprise by now specifically including the supply of electronic services separately and was again amended in 2015. The amended definition of an enterprise presently reads as follows:

“The supply of electronic services by a person from a place in an export country, where at least two of the following circumstances are present:

- The recipient of those electronic services is a resident of the Republic;
- any payment to that person in respect of such electronic services originates from a bank registered or authorised in terms of the Banks Act (94 of 1990);
- the recipient of those electronic services has a business address, residential address or postal address in the Republic.”

At least two of the requirements from the definition of an enterprise need to be met before electronic services would be included in the definition of an enterprise and as a result will be subject to VAT in terms of Section 7(1)(a) of the VAT Act. The electronic services will have to be supplied by a person that would normally not be a vendor, from an export country to either a South African resident or a person that has a permanent address in South Africa who pays the person from the export country from a registered bank in South Africa.

This definition refers to a supplier of electronic service in an export country. Under the new definition of an enterprise a foreign service provider is now liable to register as a vendor in terms of Section 7(1)(a) whereas they were previously excluded because they did not conduct business in the Republic or partly in the Republic.

Where previously VAT on foreign supplied electronic services only qualified in terms of Section 7(1)(c)-imported services, now with the amendment of the VAT Act foreign

suppliers also qualify to register for VAT in terms of Section 7(1)(a). However if the supply of electronic service is levied per Section 7(1)(a) it cannot attract VAT per Section 7(1)(c) as well.

Therefore electronic services rendered by a non-resident to a South African could clearly be included in Section 7(1)(a) of the VAT Act as supplies that would attract VAT if the supplies exceed the registration threshold R50 000.

2.6 DEFINITIONS OF ELECTRONIC SERVICES (E-COMMERCE) IN SOUTH AFRICA

Electronic services or e-commerce transactions do not have one definition that encompasses all its attributes (Bardopoulos, 2012: 57). The definitions evolved over time and many countries have defined e-commerce and the various definitions will be unpacked below.

2.6.1 PREVIOUS DEFINITIONS APPLIED

In the South African context the Green Paper on Electronic Commerce for South Africa (2000) asked “What is e-commerce?” and defined it as follows:

The use of electronic networks to exchange information, products, services and payments for commercial and communication purposes between individuals (consumers) and businesses, between businesses themselves, between individuals themselves, within government or between the public and government and, last, between business and government. This definition encompasses the many kinds of business activities that are being conducted electronically, and conveys the notion that electronic commerce is much more comprehensive than simply purchasing of goods and services electronically (Department of Communications, 2000).

The draft Taxation Laws Amendment Bill, (TLAB) 2013 was published in 2013 and e-commerce services were defined as follows:

The supply of any services where the placing of an order and delivery of those services is made electronically.

Werkmans Attorneys in their commentary on the VAT registration requirements for e-commerce suppliers state that it is unclear as to whether the legislator aimed to tax all goods ordered and delivered online or whether it aimed to include professional services (Lessing, Mazansky, Rood, McGurk & Malan, 2013).

With the introduction of the new electronic services definition in 2013 there was uncertainty regarding which specific services this definition encompassed and therefore which services would be subject to VAT. The amended definition introduced in 2014 would go on to list these services.

2.6.2 CURRENT DEFINITION OF E-COMMERCE SERVICES

In 2014 the definition of electronic services was amended to address the uncertainty. Section 1 of the VAT Act presently defines “electronic services” as “*services prescribed by the Minister by regulation in terms of this Act*”. Thus one would have to refer to the Regulation published by the Minister to determine the list of services included in the definition of electronic services.

When comparing the broad definition of e-commerce in the Green Paper on Electronic Commerce for South Africa and the Australian Taxation Office definition Bardopoulos (2012:58) stated that one was a wide definition and the other a narrow definition; however, it aimed to achieve the same thing. A narrow definition may be more flexible and a broad definition may not be adequate enough to cover all the aspects of e-commerce. The same can be said for the previous definition of electronic services in the VAT Act and the amended definition in the Regulation.

The list provided in the Regulation cannot be exhaustive and include all electronic services that the VAT rules would apply to however it provides a level of guidance as to what the definition encompasses. The short brief definition was vague and lacked guidance however it was more flexible as it could be interpreted to include a vast amount of services.

The enactment of the Regulation on electronic services was aimed at providing a clear distinction of what constitutes an electronic service per the definition of the VAT Act and details which digital products and services will be subject to the 14% VAT. The

Regulation does not provide an exhaustive list of electronic services, it was found that the scope of the electronic services was too wide and this Regulation was aimed at reducing the scope, however, and simplifying the application of the VAT Act. It should be noted that import services not listed in the VAT Act could still be subject to VAT per the VAT Act (Department of National Treasury, 2014). The regulation is aimed at clearing up some misunderstandings regarding what is included in the definition of electronic services (Deloitte, 2014). The Regulation is similar to that of the European Union (EU) per Annexure 1 to the council Regulation of 17 October 2005. One of the nine regulations from the Regulation will be selected for the purpose of this case study which will be discussed in Chapter 3.

It has been reported that with the introduction of the new VAT rules on electronic services the South African VAT revenue base stands to increase by R980 million. The Regulation will bring the VAT regime in line with international guidelines (Mungadze, 2015).

2.6.3 THE REGULATION

The Regulation lists the services that meet the definition of electronic services per the VAT Act. The services are listed in the following categories:

- Regulation 3-educational services,
- Regulation 4-games and games of chance,
- Regulation 5-internet-based auction services
- Regulation 6- miscellaneous services and
- Regulation 7-subscription services are electronic services where such services are supplied by means of any electronic agent, electronic communication or the internet for any consideration (South Africa, 2014:4-6).

Uncertainty exists as to what is meant by certain terms in the Regulations. A question arises about whether the ordinary dictionary meaning of the services should be applied when looking at the VAT implications?

In its first interim report the Davis Tax Committee (2014:38) gave an example that the meaning of a subscription service maybe has a different interpretation based on the

different dictionary meaning. It was held that “if the dictionary meaning is applied, it could be construed to mean that payment must be made to access a certain service. Where, for example, a subscription fee is paid to enable the user to carry out transactions on a website, the service is subject to VAT. However, where no such subscription fee is payable but a service is fee is charged on individual transactions carried out on the website, the transaction would escape VAT”.

A further problem with a list is that it may be unsatisfactory in listing all the services that it's required to address.

When determining whether an e-commerce transaction would qualify for VAT, the above definitions need to be considered individually and an assessment needs to be made as to whether the service provider falls into the VAT net. Once the requirements for the levy of VAT are met the taxpayer would then be required to register for VAT. The registration of VAT carries with it some guidelines which will be considered below.

2.7 REGISTRATION FOR VAT AND VAT THRESHOLD

Section 23 of the VAT Act governs the registration of a person providing supplies in the course of carrying on an enterprise.

Section 23(1)(a) of the VAT Act prescribes a compulsory registration threshold and requires that any person carrying on an enterprise at the end of any month where the total value of taxable supplies made in the period of 12 months ending at the end of that month exceeds R1 million is liable to register for VAT (VAT Act).

Section 23(1A) was introduced specifically for e-commerce transactions and it states that every person from an export country who supplies electronic services to a person within the Republic or payment originates from a bank account from the Republic would be liable to be registered at the end of any month where the total value of taxable supplies made by that person has exceeded R50 000 (VAT Act). This would apply to a vendor in terms of Section 7(1)(a) of the VAT Act.

SARS has issued a VAT Registration Guide for Foreign Suppliers of Electronic Services (referred to as FESEs) to assist with the registration process. Once the value of supplies of the FESEs exceeds the R50 000 threshold, the supplier is required to

download a VAT 101 Form which is available on the SARS website. Once the registration form has been completed it can be submitted by email back to SARS along with supporting documents where it will be assessed and a notice of registration will be issued to the Foreign Suppliers of Electronic services (“FESEs”). The FESEs can then register for e-filing (SARS, 2014).

The registration via email was aimed at streamlining the VAT registration process and simplifying it for FESE (SARS, 2014). The FESE needs not have a local bank account in order to register for VAT (SAICA, 2014). In its first interim report the Davis Tax Committee (2014:33) held that the South African tax authorities have tried to adhere to the principle of “efficiency” as stated in the OECD guidelines which requires that the compliance costs of the taxpayer and tax authorities be kept to a minimum.

In terms of the VAT Registration Guide for Foreign Suppliers of Electronic Services the following concessions were made:

- The foreign supplier of electronic services is not required to
 - have a physical presence in the Republic;
 - have a South African bank account;
 - appoint a representative vendor (this is only required for administrative purposes);
 - be registered on the invoice basis, may account for VAT on payments or cash basis.
- The supplier could complete the VAT registration on line (SARS, 2014:3)

The European Union (EU) similarly implemented “simplified” registration and reporting rules for FESEs. The FESE, however, was seen to still be at a disadvantage as FESEs still had to bear higher costs of compliance caused by the need to analyse each customer’s tax legislation. This creates neutrality deficits (Pronina, 2011:30).

The higher costs created by this legislation could be viewed as inefficient as they may not be “achieving maximum productivity with minimum wasted effort or expense” as mentioned in par 1.3. In par 2.8.3.2 efficiency is described as cost-effectiveness and it states that cost-effectiveness should be a driving force when determining tax laws.

With the higher cost of compliance created by the registration process this legislation might not be efficient.

2.8 INTERNATIONAL GUIDELINES ON APPLYING INDIRECT TAXES ON E-COMMERCE TRANSACTIONS

In an article dealing with the VAT rules in South Africa that had to be updated for the internet age, published in 2013, Bardopoulos was quoted as saying "It is Treasury's intention to comply with international trends, the services included as a minimum should include website hosting, data warehousing, software supplies and updates, the provision of images, text, music, films and games, gambling games, and subscriptions to databases and websites" (Jooste, 2013).

Jooste (2013) affirms this view by stating that it is the intention of Treasury to align the VAT rules to international jurisdiction including the EU. The Davis Committee was set up to streamline the tax policy framework (Davis Committee, 2014a). The Davis Committee assesses the South African Tax policies against international trends (Davis Committee, 2014b). One of the main focuses of the Davis Committee is to determine the impact of tax on e-commerce on the South African tax revenue base (Davis Committee, 2014b).

Section 232 of the Constitution of the Republic of South Africa (108 of 1996) (the Constitution) states that when South African legislation is applied the courts must carefully ensure that it is consistent with international law. Only a provision or parliament or constitution that clearly contradicts the international law will be superior to international law (Dugard, 1997). With this section the supreme law of the country requires that international law must be considered when applying local legislation. This becomes increasingly important when comparing the South African VAT legislation on foreign e-commerce suppliers and international practices. Section 231 of the Constitution further states that South Africa is bound by international agreements that it signs. For tax purposes double tax agreements signed by South Africa take precedence over South African domestic law as they are binding in terms of the Constitution (CSARS v Van Kets WC, 2011).

The above outlines the importance of South Africa considering international tax trends when reviewing and formulating its tax policies. For the purposes of this dissertation the Convention on the Organisation for Economic Co-operation and Development (OECD) and the EU policies and guidelines on VAT on e-commerce transactions will be assessed to obtain an international perspective on the topic.

2.8.1 THE OECD

The OECD dates back to World War II (Anon, 2011). It was formed by the US Marshall Plan in 1947 which aimed at rebuilding after the continent was devastated by war (OECD, 2015b). The OECD came into being in 1948 and was formally established on 30 September 1961, when the Convention became effective (Anon, 2011). The OECD is an international organisation that was established to encourage cooperation and coordination among member countries, in an attempt to find resolutions to common economic problems. The organisation currently consists of 34 countries and has become a leading authority through its publication of reports, books, statistics, research etc. on topical tax matters (OECD, s.a). South Africa is not a member of the OECD (Van Zyl, 2013; OECD, 2014). South Africa is a partner of the OECD (OECD, 2015e). In the 2015 South African Budget speech the Minister of Finance, Mr Nene, stated that there would be proposed amendments to the digital economy that will be in line with the guidelines recommended by the OECD in their report on Base Erosion and Profit Shifting (BEPS) (Camay, 2015).

The OECD monitors global developments in various economic activities and one of its focuses is tax. The OECD collects data from various sources, analyses the data collected, reviews policies and informs the member states of the tax policies and publishes this information (OECD, 2015e). The OECD has published guidelines on international VAT or Sales tax and established what the principles of a good VAT system are i.e. neutrality, simplicity, efficiency, flexibility etc. which will be discussed below in par 2.7.3 (Van der Merwe, 2003).

The OECD provides guidelines and principles and informs countries about international trends. South Africa may not be a member state but it should consider the international law and it should look to an organisation such as the OECD for

guidance when determining its tax policies (Van Zyl, 2013). The OECD recognised that cross border e-commerce transactions created challenges within the EU and other nations (McLure, 2003).

Already in 1999 the OECD hosted 29 member countries and eleven non-member countries at the Ottawa Ministerial Conference on electronic commerce (OECD, 1999). This conference was aimed at exploring the key issues relating to taxation on e-commerce (OECD, 1999). In its first interim report the Davis Tax Committee (2014:31) held that the leaders welcomed the 1998 OECD Report: Electronic Commerce: Taxation Framework conditions and endorsed taxation principles (Davis Tax Committee, 2014:31).

The OECD has published numerous works in the sphere of taxation on e-commerce and the various challenges faced in this area and are a valuable source of information.

2.8.2 THE EUROPEAN UNION (EU)

The founding fathers, namely Belgium, France, Germany, Italy, Luxembourg and the Netherlands founded the EU after World War II (European Union, 2015a). The EU was formed after the European neighbouring countries decided to stop the bloodshed that was caused by the war in the region and unite under a common goal of forming a single market (European Union, 2015a). Today the EU consists of about 28 member countries (European Union, 2015b). According to Ginsberg (cited by Van Zyl, 2007) the EU is a political and economic union aimed at ensuring the free movement of the trade of goods and services among its member states.

Common systems and policies are adopted among EU member states. An example of this is the EU VAT Directive. This is similar to a multi-national treaty agreement between its member states. The EU VAT Directive addresses electronically supplied services (Bardopoulos, 2012).

The EU influences international tax policy and trends due to its 28 member composition. The EU was one of the first jurisdictions to enact VAT on e-commerce transactions and they have made advancements in this field. It is thus important that the guidelines of the EU be considered (Fryer, 2014:38). The EU VAT Directive will

assist in analysing the effectiveness of the South African VAT regulation on e-commerce due to its similarities to the Regulation on electronic services published by the minister.

2.8.3 PRINCIPLES OF A GOOD TAX SYSTEM

In its first interim report the Davis Tax Committee (2014:32) held that it is imperative that the different tax authorities throughout the world adopt VAT provisions that do not result in double taxation in another VAT jurisdiction. The main objective of this dissertation is to ascertain whether the current VAT provisions are efficient and effective to practically implement on electronic services taking place in South Africa. The effective nature of the South African VAT policies cannot be evaluated without considering whether it meets the international general principles of a good tax system. These principles stem from Adam Smith in 1776 in “Wealth of Nations”. He identified four norms namely equity, certainty, convenience and economy.

The OECD adopted a neutral approach to the taxation of e-commerce transactions (Fryer, 2014). This meant that the OECD would not discriminate against e-commerce service providers by enacting additional taxes that conventional service providers were not subject to (Bleuel & Stewen, 2000).

The OECD international VAT or GST Guidelines (OECD, 2013b) further lists seven principles of a good VAT system. It is recommended that the adoption of tax on electronic services should be aligned with these general principles of a good tax system which require:

- Neutrality;
- Efficiency;
- Certainty;
- Simplicity;
- Effectiveness;
- Fairness; and
- Flexibility.

The above guidelines are not there to prescribe what revenue services should do but are there to provide uniformity in the treatment of consumption taxes through various jurisdictions.

These principles will be referred to throughout this dissertation to assist in answering the research question. The principles are briefly elaborated on below:

2.8.3.1 NEUTRALITY

Taxation should be unprejudiced or unbiased to all taxpayers. Both traditional and ecommerce transactions should be treated in a manner that is equitable (OECD, 2001). E-commerce transactions should be subject to taxation if their 'physical equivalents' are subject to taxation (Pinkernell, s.a.).

It is thus important that we consider whether the Regulation and the VAT legislation that supports the definition of e-commerce services is neutral and applies the same rules to all taxpayers and does not favour suppliers of physical services over FESEs. This will be assessed in chapter 5.

2.8.3.2 EFFICIENCY

Cost-effectiveness should be a driving force when determining tax laws. The aim should be to minimize the cost of compliance and the administrative burden on both the taxpayer and the tax authorities involved (OECD, 2001). Efficiency is a fundamental principle in taxation. From a state's perspective it is fundamental that the cost of collecting taxes should not outweigh its benefits or else it defeats the purpose (Rendahl, 2009). This will be assessed in chapter 5.

When applying the Regulation and the VAT legislation to FESEs there needs to be considered whether these processes are efficient. Does the cost of obtaining tax revenue from FESEs create an insurmountable administrative burden? If so the legislation will not be efficient or effective. This will be assessed in chapter 5.

2.8.3.3 CERTAINTY

Tax laws should be clear and provisions should be consistently applied by taxpayers (OECD, 2001). Certainty and simplicity are crucial considerations when drafting legislation and the taxpayer should be able to foresee the consequences of its actions (Rendahl, 2009).

An additional question arises on whether the Regulation is clear. Can it be picked up by any FESE big or small and be consistently applied? Would FESEs be able to foresee the tax implications? This will be assessed in chapter 5

2.8.3.4 SIMPLICITY

The OECD has focused on simplification when it comes to their work on consumption taxes. The aim is to keep the compliance burden to a minimum and removing potential barriers to growth and development. A simple system would decrease compliance cost for the taxpayer, increase level of compliance and decrease the administrative burden of tax authorities (Steyn & Van Zyl, 2010).

The Technology Advisory Group (TAG) is a group formed by the OECD that has undertaken a range of work with the Consumption Tax and Professional Data Assessment. The consumption tax TAG publication identifies some simplification initiatives which include:

- Standardised invoice formats available through electronic invoicing
- Standardised VAT returns
- Standardised audit requirements
- E-commerce VAT reporting and record keeping
- Online electronic filing system where suppliers can verify their VAT registration, compliance status and other relevant data (OECD, 2001).

These principles or initiatives will be critically evaluated against the South African VAT on e-commerce in chapter 4 and 5 to determine whether they comply with this principle of simplicity.

2.8.3.5 EFFECTIVENESS AND FAIRNESS

The aim of taxation is to ensure an equitable share of tax is paid at the right time while reducing BEPS (OECD, 2001). Rendahl simply explains effectiveness and fairness as the “right amount of tax at the right time” (Rendahl, 2009).

It needs to be considered if the South African VAT system on e-commerce would be found to be effective and fair. This principle is considered throughout chapter 5.

2.8.3.6 FLEXIBILITY

Taxation should not be rigid and should evolve with the environments of operation. It should keep abreast of technological and commercial developments (OECD, 2001). Flexibility is fundamental for the taxation of e-commerce. Flexibility could then also involve legislation coping with an ongoing development in society (Rendahl, 2009).

2.8.4 CATEGORIES OF E-COMMERCE TRANSACTIONS

When determining the impact of VAT on e-commerce transactions the following three categories of e-commerce transactions should be considered:

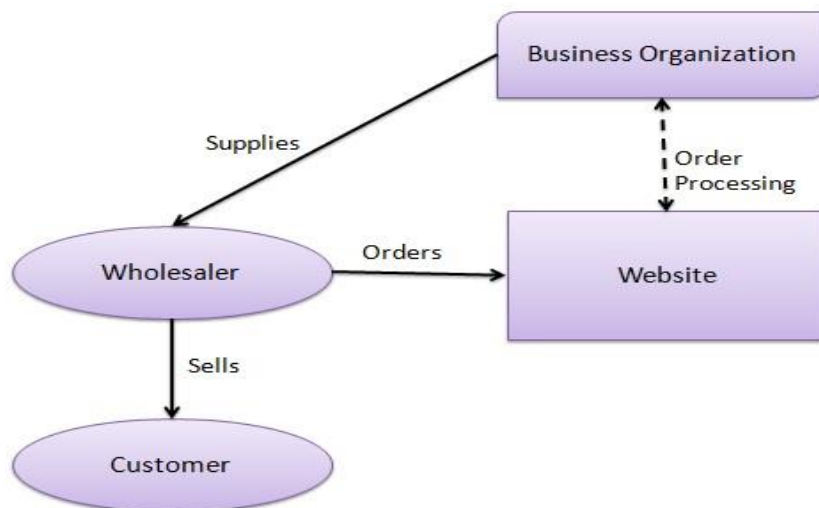
2.8.4.1 SUPPLY OF E-COMMERCE GOODS TO BUSINESS AND PRIVATE CONSUMERS

These are usually transactions of tangible products which are physically delivered and cleared through customs and thus easy to track as they enter the country. The recipient of the goods is required to pay VAT on the goods received (Steyn & Van Zyl, 2010).

A problem arises when the goods received are intangible and no physical delivery takes place. This presents a difficulty for authorities to determine where consumption takes place (Steyn & Van Zyl, 2010).

2.8.4.2 SUPPLY OF E-COMMERCE GOODS AND SERVICES FROM BUSINESS TO BUSINESS

Figure 2.2 BUSINESS TO BUSINESS

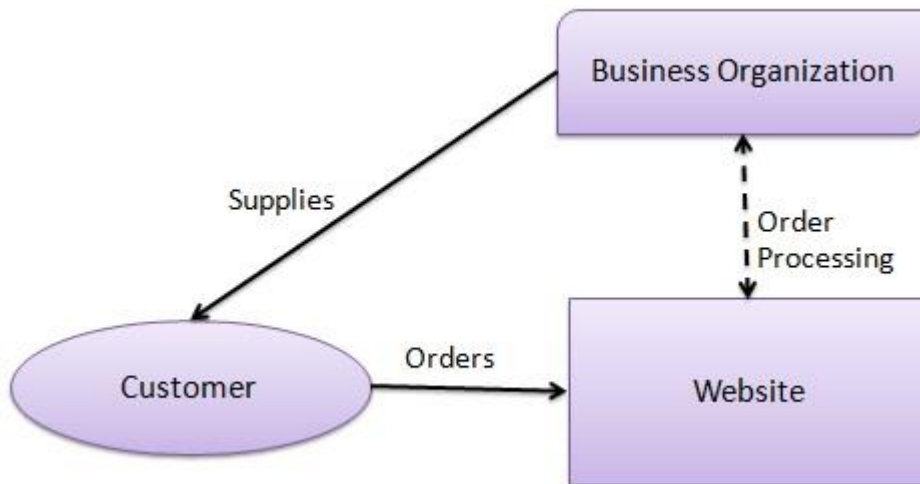


Source: Tutorial point E-Commerce - B2B Model, 2015

The Business to Business (“B2B”) model sells its product to an intermediate buyer who then sells the product to the final customer (Tutorial point, 2015). B2B transactions are easier to administer as revenue authorities have more control over registered businesses. The problem arises with transactions between unregistered businesses (Steyn & Van Zyl, 2010).

2.8.4.3 SUPPLY OF E-COMMERCE GOODS AND SERVICES FROM BUSINESS TO CONSUMER (B2C)

Figure 2.3 BUSINESS TO CONSUMER



Source: Tutorial point E-Commerce - B2C Model, 2015

Business to consumer is the sale of goods and services over the internet from a business directly to a consumer (Tutorial point, 2015).

These transactions become very tricky to track as private consumers are not registered and often pay small amounts of VAT on e-commerce transactions (Steyn & Van Zyl, 2010).

Therefore for the purpose of this dissertation only the B2C model will be considered due to the challenges that arise within the B2C e-commerce environment.

2.8.5 INTERNATIONAL DEFINITIONS OF ELECTRONIC SERVICES (E-COMMERCE)

The VAT system in the EU has evolved over the years and the changes have been based on the recommendations of the OECD. The EU VAT system is similar to the South African VAT system (Fryer, 2014:35).

Based on the above assessment this dissertation will evaluate the South African VAT provisions' implications on e-commerce transactions based on the EU and the OECD guidelines. This analysis will commence with the analysis of the definition of e-commerce from both the EU perspective and the OECD. E-commerce has various definitions which will be considered below.

Many similarities exist between the South African definition of e-commerce and the OECD and the EU. The method used to place the order is similar however many of the definitions include different types of services. The definitions are often open to interpretation.

2.8.5.1 OECD DEFINITION OF E-COMMERCE

The OECD has done extensive work in the formulation of the framework on e-commerce.

The OECD defines e-commerce as follows:

An e-commerce transaction is the sale or purchase of goods or services, conducted over computer networks by methods specifically designed for the purpose of receiving or placing of orders. The goods or services are ordered by those methods, but the payment and the ultimate delivery of the goods or services do not have to be conducted online. An e-commerce transaction can be between enterprises, households, individuals, governments, and other public or private organizations. To be included are orders made over the web, extranet or electronic data interchange. The type is defined by the method of placing the order. To be excluded are orders made by telephone calls, facsimile or manually typed e-mail (OECD, 2011).

The above OECD definition is similar to the South African one per the Green Paper on Electronic Commerce discussed in 2.6.1. The definition is wide and encompasses a wide range of e-commerce transactions that can fall within the definition. According to Mahlunge (2014:12) e-commerce can have a narrow definition that focuses on specific types of transactions performed over the internet or it can have a wide definition that is all encompassing of various different transactions that occur over the

internet. The new South African definition discussed in 2.6.2 is a narrow definition and lists the electronic services that fall within the definition.

2.8.5.2 OTHER GENERAL DEFINITIONS:

According to Krensel (2014:6) “electronic commerce refers generally to all forms of transactions relating to commercial activities, including both organization and individuals that are based upon the procession and transmission of digital data including text, sound and visual images”.

2.8.5.3 EUROPEAN DEFINITION OF E-COMMERCE

2.8.5.3.1 DIRECTIVE 2002/38/EC OF 7 MAY 2007

The EU was one of the first to regulate taxation on e-commerce transactions and this was achieved with the consideration of the OECD recommendations (Pronina, 2011).

The Directive 2002/38/EC of 7 May 2007 provided a list of the services that would be “electronically supplied services” (Pronina, 2011). The list was then updated in Annexure L of the EU Directive (2006) which lists all electronically supplied services.

In article 7 of the Regulation 2011/282 the EU defines supplied services as *Electronically supplied services’ as referred to in Directive 2006/112/EC shall include services which are delivered over the Internet or an electronic network and the nature of which renders their supply essentially automated and involving minimal human intervention, and impossible to ensure in the absence of information technology* (European Commission, 2011).

In its first interim report the Davis Tax Committee (2014) held that the list provided by the directive is clear as to items that constitute electronically supplied services. This specifically defined these as services and not goods. A problem arises with a list of services as the list of services is not an exhaustive list and “it is the degree of human intervention” that is decisive for the classification of e-commerce services (Bardopoulos, 2012:157). The same problem can be identified in the South African definition of electronic services that is dealt with in the Regulation.

2.9 RELEVANCE OF CONSUMPTION TAXES

Consumption taxes could simply be explained as taxes aimed at the purchase of goods and services. VAT is a consumption tax as it is indirectly levied on the supply of goods and services (Garner, 2005).

The taxation of e-commerce transactions is an international phenomenon and the OECD identified a need to coordinate the domestic VAT systems with international trade. A set of guidelines that govern the application of indirect taxes on e-commerce transactions were compiled. The guidelines provided by the OECD contain a framework that details the core elements that should be considered when dealing with these transactions. The core elements of these guidelines are general principles. These guidelines will be discussed below.

The Taxation Framework Conditions were compiled by the Committee on Fiscal Affairs of the OECD in consultation with the European Commission, the World Customs Commission and the business community (OECD, 1998).

In 1998 the above parties met to try resolve the issues created by e-commerce transactions. They came up with a framework to try to prevent double taxation and resolve the question of whether e-commerce transactions are goods or services. The core elements of the Taxation Framework Conditions can be summarised into 3 points as follows:

For the purpose of consumption taxes on cross-border transactions:

1. Taxation should occur in the jurisdiction where consumption of supplies takes place;
2. The supply of e-commerce transactions should not be a supply of goods thus it is a supply of services;
3. Where domestic businesses and other organisations acquire digital goods from suppliers outside the country, domestic tax authorities should consider “reverse charge”, self-assessment or other equivalent mechanisms where this would give immediate protection of their revenue base and of the competitiveness of domestic suppliers”(OECD, 1998a).

2.10 CONCLUSION

This chapter has outlined the South African VAT legal framework and discussed the definitions and requirements for VAT to be imposed on an e-commerce supply in South Africa. The international principles for a good tax system on e-commerce have been outlined, which will assist in outlining whether the treatment of the VAT on e-commerce transaction in South Africa is practical, efficient and effective, and in line with international norms and requirements of a good tax system and will be further considered in chapter 5. The international definitions of e-commerce were discussed, thus enabling one to identify an e-commerce service. Some deficiencies relating to the legislation have been identified and will be unpacked further in subsequent chapters. This chapter addressed the research objective as identified in par. 1.4.2(i). Now that an understanding has been created on what constitutes an e-commerce service the next chapter will then aim at identifying the focus of the case study.

CHAPTER 3: SELECTION OF THE SERVICE PER THE REGULATION AND DESCRIPTION OF THE APPLE ITUNES SERVICE PROVIDED TO CUSTOMERS

3.1. INTRODUCTION

The purpose of this chapter is to outline the selection of the service that will be the focus of the case study from the Regulations prescribing electronic services for the purpose of the definition of “electronic services”. A description of the selected Apple iTunes service provided to the customers will be done. It will also note the limitations of the study. This chapter will address the research objective as identified in par. 1.4.2 (ii).

3.2. SELECTION OF THE ELECTRONIC SERVICE FROM THE REGULATION

In Chapter 2, the definition of electronic services was analysed. It was determined that Section 1 of the VAT Act defines “electronic services” as “services prescribed by the Minister by regulation in terms of this Act”. The Regulation lists the services that meet the definition of electronic services as per the VAT Act. The services are listed in the following categories:

- Regulation 3-educational services,
- Regulation 4-games and games of chance,
- Regulation 5-internet-based auction services,
- Regulation 6- miscellaneous services and
- Regulation 7-subscription services are electronic services where such services are supplied by means of any electronic agent, electronic communication or the internet for any consideration (South Africa, 2014:4-6).

For the purposes of this study, only regulation 6 dealing with miscellaneous services will be considered which lists the supply of e-books, film, music, images and software. E-books include electronic publications. Films include movies, video clips etc. Music includes audioclips, songs and jingles. Images include photographic material etc. (South Africa, 2014:5:6).




3.3. LIMITATION OF THE STUDY

An assumption is made that Apple is a foreign supplier. No assessment is performed in this study to verify whether or not Apple is a resident or whether it has a permanent establishment in the Republic. The transactions described below can be classified as B2C transactions. B2C transactions are the focus of this study as considered in par. 2.8.4.3

3.4. SELECTION OF THE SUBJECT OF THE CASE STUDY

As mentioned in par. 1.1.1, Apple iTunes is one of the leading media player software applications in the world. According to PC Magazine Encyclopaedia (2014), iTunes is used by millions of people to gather and download music, movies, videos and applications on their iPads, iPhones and iPods from Apple's online store. Apple iTunes operates from Apple devices, namely Apple computers, iPod, iPhone or iPad. Apple devices allow users to access Apple products on the internet anywhere in the world (Apple Inc. 2015c). Movies, tv shows, music, audio clips etc, can all be downloaded using the iTunes software (Apple Inc, 2015a). Due to the popularity of Apple iTunes and the platform that is used to render the services to customers, Apple iTunes has been selected to be the focus of the study.

What Content is available on iTunes

Country	Books	Songs	Itune Lp's	Audio Books	Music Videos	Ring Tones	Tones
 South Africa		✓	✓		✓	✓	✓
 United States	✓	✓	✓	✓	✓	✓	✓
 United Kingdom	✓	✓	✓	✓	✓	✓	✓

Source: Apple Inc, 2015b

The provision of audio clips, songs, movies and other media by Apple using its iTunes platform, constitutes an electronic service per Regulation 6. The assumption made is that the provision of electronic services by Apple iTunes to South African consumers constitutes a provision of an electronic service by a foreign electronic supplier. Thus the VAT rules governing electronic services would be applicable as discussed in par 4.3.

3.5. HOW MANY iTUNES USERS ARE THERE?

According to Ulloa (2014), in 2014 Apple had about 800 million iTunes accounts and most of these accounts have credit information linked to them. According to Arora (2014), there have been R70 million downloads from iTunes. These figures represent Apple users from all over the world. In South Africa FESEs are required to file monthly VAT 201 returns (Davis Committee, 2014). This creates an administrative burden on FESEs as they do not only have to deal with South African tax requirements but tax requirements from all other tax jurisdictions across the world. The tax authorities will

thus have to consider achieving maximum collection of taxes with minimum effort or expense, which is the definition of efficiency as discussed in par 1.3. The burden of compliance created by the VAT legislation on e-commerce transactions and challenges that arise due to the sheer volumes of transactions that FESEs are faced with, will be dealt with in Chapter 5.

3.6. HOW DOES iTUNES WORK?

A customer is able to purchase songs and other offered media on iTunes in the respective countries that Apple services. The detailed services available in each specific country are listed on the Apple site (Apple Inc, 2014b).

In order to determine whether or not the services are subject to the VAT legislation on e-commerce transactions, it is imperative to obtain an understanding of how the services are provided to customers.

In order for a customer to purchase and download media on the iTunes platform, there are a few steps to be followed:

1. A customer needs an Apple device;
2. The customer is required to have internet access on the Apple device;
3. The customer is required to log into the Apple iTunes store using the customer designated Apple ID;
4. The customer is required to browse the store and select the media they wish to download;
5. The customer is then required to confirm the transaction by selecting the price offered, or the free button where applicable, and make the purchase;
6. The purchase amount is then deducted from the customer's gift card or the customer can make payment using their credit card (Wikihow, 2014).

According to Apple Inc (2015d) the customer can use the following payment methods for an iTunes transaction: Credit cards, Content codes, Store credit, including iTunes Store Gift Cards, Gift Certificates, allowances, ClickandBuy, PayEase, PayPal and UnionPay. It should however be noted that the payment methods differ from country

to country, based on availability of a specific method. In South Africa you can pay for transactions using credit card, gift cards and paypal.

3.7. THE APPLE ID

In order for a customer to make a purchase on iTunes, they are required to have an Apple ID (Apple Inc, 2015d).

According to Apple Inc (2014a) “ ... an Apple ID is a user name you use for everything you do with Apple. Creating an account for an Apple service, such as the iTunes Store or the App Store, creates an Apple ID. Apple ID allows you to access other Apple services”.

Specific information is required when creating an Apple ID. The customers are required to provide their name and surname, email address, location (postal code, physical address), their preferred payment method and billing information (Apple, 2014a).

The above information will assist the service provider in identifying where the customers are and in turn the tax jurisdiction where tax liability accrues. It should be noted that a concern that arises from the above is that the information could be manipulated by the customer, resulting in inaccurate information being used by the service provider for reporting purposes. This concern regarding the documentation will be addressed in Chapter 5.

A further concern to be noted is that Apple is required to identify the place of consumption of the services provided to customers in order to satisfy the VAT legislation requirements. The challenges facing the FESEs in identifying the place of consumption and the practicality, effectiveness and efficiency thereof will be addressed in Chapter 5.

3.8. CONCLUSION

The regulatory framework was analysed and Regulation 6 miscellaneous services selected as the focus of this study. A relationship was established between the services referred to in Regulation 6 and the services provided by Apple on its iTunes

platform. An explanation of how to download iTunes was provided and it was noted that given the large volumes of transactions that Apple has on its iTunes platform, the compliance with tax requirements from different jurisdictions would prove to be challenging. The secondary objective as identified in par 1.4.2 (ii) was hereby successfully addressed. Chapter 4 will consider the application of the legislation to services that Apple iTunes provides to customers.

CHAPTER 4: APPLICATION OF THE SA VAT LEGISLATION TO ELECTRONIC SERVICES THAT APPLE iTUNES PROVIDES TO CUSTOMERS IN SOUTH AFRICA

4.1 INTRODUCTION

The purpose of this chapter is to perform a case study to understand how the South African VAT legislation on e-commerce could be applied practically, effectively and efficiently to the electronic services rendered by Apple iTunes. The case study will outline the process of the transactions and the various considerations that must be made in applying the legislation. The deficiencies noted in the application of the case study will be discussed. This will address the research objective as identified in par. 1.4.2(iii).

The practicality, effectiveness and efficacy of the VAT application within the e-commerce environment will be assessed. The case study will offer a practical example of the application of the SA VAT legislation.

4.2 BACKGROUND FACTS

Apple's headquarters are located in Cupertino, California in the United States of America but due to the growth and dominance the company has established offices globally (Apple Inc, 2014).

A South African Apple device user logs on to iTunes and purchases music and movies valued over R100. Apple ("supplier") sells the Customer ("recipient") music or movies from the iStore. The music and movies are then consumed in South Africa.

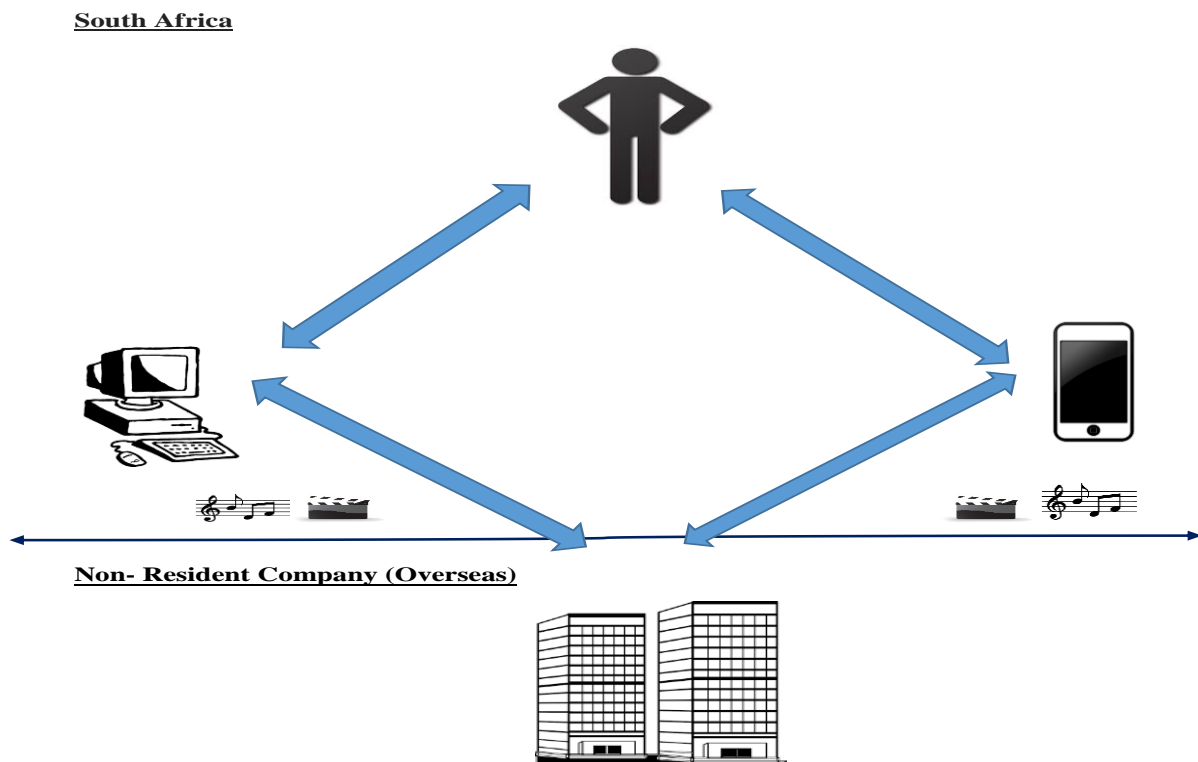
Apple provides the service via the internet through an application therefore Apple provides the service remotely and no physical presence is required on the part of the supplier. This supplier fails the physical presence test required for taxation for income tax purposes as discussed in par. 2.3.

Even though there is no Permanent Establishment (PE) or physical presence, for VAT purposes section 7(1)(a) specifically includes electronic services from non-residents to residents in the definition of an enterprise. Therefore it makes it clear when it would be applicable.

The following assumptions have been made in order to illustrate the VAT consequences to this transaction:

- For the purpose of this study only iTunes transactions relating to movies and music will be examined.
- Apple will have to meet the requirements of the VAT Act to be a VAT vendor in South Africa.
- Apple utilises multiple servers located outside South Africa.
- The transaction is a B2C transaction.
- Apple is a FESE.
- The music or movie purchased by the consumer is above R100.
- The customer is located in South Africa and is a holder of a South African Bank account.
- The merchandise is consumed in South Africa
- This case study excludes the assessment of any income tax principles.

The application of VAT to the Apple transaction will be illustrated as follows:



4.3 APPLICATION OF THE SOUTH AFRICAN VAT LEGISLATION ON THE TRANSACTION

An understanding of the South African VAT structure was obtained in chapter 2. This section will address how the legislation impacts on the application to e-commerce transactions to assess the practicality, effectiveness and efficiency. The application of VAT in a virtual world does not seem to differ significantly from the traditional application of VAT. The differences in application come in as a result of the place of supply rules (Bardopoulos, 2012).

In the application of the VAT rules on the transactions it is crucial that the requirements of the imposition of VAT be considered and applied to the above-mentioned scenario.

Section 7(1) of the VAT Act deals with the imposition of VAT. VAT is calculated at a rate of 14% of the value of the supply once all the concepts below are met. In order for a transaction to attract VAT, in terms of this section, the following requirements must prevail:

- d) There must be a **supply by a vendor of goods or services** supplied by him on or after the commencement date in the course or furtherance of any **enterprise** carried on by him;
- e) When dealing with the **importation** of any **goods** by any person; and
- f) When dealing with the **supply** of any **imported services by any person** (VAT Act).

VAT on e-commerce transactions may be imposed under Section 7(1)(a) or Section 7(1)(c) (VAT Act). Once the service has been taxed in terms of Section 7(1)(a) it cannot be taxed under Section 7(1)(c.) This prevents double taxation (Van Zyl, 2013). For the purpose of this case study we have assumed that Apple is a registered vendor and therefore Section 7(1)(a) would be applicable.

The various requirements for the imposition of VAT will be discussed below.

4.3.1 IS THERE A SUPPLY?

For the purposes of analysing the VAT implications the supply must be examined. The definition of “supply” is broad. A “supply” as defined by the VAT Act “includes performance in terms of a sale” (VAT Act). The Oxford dictionary defines supply as to “provide” or “furnish” (Silver & Beneke, 2013). For a supply to occur there must be at least two parties to the transaction namely the “supplier” and the “recipient” (Silver & Beneke, 2013). The VAT Act defines recipient as “in relation to any supply of goods or services, means the person to whom the supply is made” (Stiglingh, Koekemoer, Van Zyl, Wilcocks, De Swardt, 2015)

There are two parties to this sales transaction as Apple performs a sale by selling music and movies on iTunes to the customer. This would constitute a supply per the definition of supply.

4.3.2 IS IT A SUPPLY OF GOODS OR SERVICES?

It is important to differentiate between the supply of service and the supply of goods as these are treated differently in terms of the VAT Act (Silver & Beneke, 2013). The definition of service per the VAT Act is provided in par 2.5.4. Differentiating the two terms is not significant for determining whether or not VAT is levied on a transaction but rather when applying the timing and value rules (Silver & Beneke, 2013). Place of supply rules and VAT collection methods differ between goods and services (Van Zyl, 2013). As discussed in Chapter 2 and 3 the supply of e-commerce transactions has been classified as a service as defined by the Regulation.

4.3.3 WAS A SUPPLY MADE BY A VENDOR?

Supplies by a non-vendor do not attract VAT (Stiglingh *et al.*, 2015). It is imperative for the application of VAT that the supplier of services be a vendor as defined (Silver & Beneke, 2013), as in terms of the VAT Act section 7(1) to be a vendor is required for the transaction to be subject to the levying of VAT. The VAT Act defines a vendor as “any person who is or is required to be registered under this Act: Provided that where the Commissioner has under section 23 or 50A determined the date from which a person is a vendor that person shall be deemed to be a vendor from that date.”

Huxham and Haupt (2013:941) support this definition by also stating that a vendor is defined as any person who is required to be registered for VAT. The VAT Act provides for compulsory registration and voluntary registration in section 23(1)(a) and section 23(3) respectively (VAT Act).

In order to register for VAT the supplier needs to manufacture supplies that exceed the registration threshold (Huxham & Haupt, 2013:941). The registration thresholds are stipulated in the VAT Act section 23. As discussed in chapter 2, Section 23(1A) was introduced specifically for e-commerce transactions, and it requires foreign e-commerce service providers who supply services to consumers within the Republic or receives payment from a bank account from the Republic to be registered at the end of any month where the total value of taxable supplies made by that supplier exceeded R50 000 (VAT Act).

It has been reported that over 205 000 iPads were sold to South African users since Apple's Launch in 2010 (Goldstuck, 2012). In 2013 the CEO of Prezence Digital, Tom Bishop was quoted as saying there were 200 000 iPhone users in South Africa (Cult of Mac, 2013). If each of these users were to purchase goods for R100 that would result in Apple having taxable supplies for VAT purposes in excess of the legislated threshold of R50 000. It is assumed that Apple is a foreign supplier of e-commerce services and as a result thereof would be required to register for VAT. Once this requirement is met Apple would constitute a vendor for South African VAT purposes. Therefore section 7(1)(a) will apply.

Where a person becomes liable to register for VAT they must register within 21 days after becoming liable (VAT Act). The onus is on the taxpayer to register (Huxham & Haupt, 2013). Based on the information above, the responsibility rests with Apple to register as a vendor once all VAT registration requirements are met in terms of which is referred to as the forced VAT registration method.

The question arises as to how the small foreign vendors will know that they are required to register for VAT in South Africa? As explained Apple is a large vendor, and this question may not be relevant to Apple; however, it may well be an aspect worthy of further exploration in a fitting research.

4.3.4 IS THE VENDOR CARRYING ON AN ENTERPRISE OR WHERE IS THE SUPPLY MADE?

The South African VAT system is based on place of consumption of services or destination principle (Janse van Rensburg, 2011). Similarly the OECD at the 1998 OECD Ministerial Conference in Ottawa agreed that VAT should be levied at the place of consumption due to it being a consumption tax (OECD, 1998). This ensures neutrality and eliminates double taxation and unintended non-taxation of consumption (Van Zyl, 2013). Should Apple carry on an enterprise or supply an imported service and exceed the compulsory registration threshold they will be required to register for VAT. For the purposes of this case study it was assumed that Apple meets the requirements for registration as a VAT vendor.

South Africa does not have a sufficient complement of supply rules (Steyn, 2010). The place where the services are consumed is not always clear and the lack of place of supply rules in the VAT Act aggravates the situation (Badenhorst, 2013).

The new definition of an enterprise attempts to create a place of supply rule with regards to e-commerce services.

As previously discussed in par 2.5.5 an “enterprise” also includes (VAT Act):

The supply of electronic services by a person from a place in an export country

- aa) to a recipient that is a resident of the Republic; or
- bb) where any payment to that person in respect of such electronic service originates from a bank registered or authorized in terms of the Banks Act 1990 (94 of 1990).

The supply of music and movies through the iTunes application is a supply of an electronic service as defined by the Regulation 6. For the purposes of this case study the recipient is a South African resident and possesses a South African bank account. Therefore within the parameters of this study Apple carries on an enterprise as defined. To properly identify the place of consumption is a problem, this could also be a recommended further field of study pursued in other dissertations.

As discussed in par 2.5, in terms of the South African VAT legislation, VAT is imposed on the supply of any imported services by any person if not consumed for purposes of the trade. Therefore if the services are consumed in South Africa they will be subject to VAT in South Africa regardless of where the source of the service is (SARS, 2007). Exports are consumed in a foreign country therefore they are subject to zero rated tax (Silver & Beneke, 2013). Where Section 7(1)(c) is applicable “Imported services” are defined by the VAT Act as services made by a supplier who is not a resident or who carries on business outside the Republic to a recipient who is a resident of the Republic to the extent that such services are utilised or consumed in the Republic otherwise than for the purpose of making taxable supplies. This is not applicable to Apple as discussed in par. 4.3.3 as Apple is a registered vendor in terms of Section 7(1)(a).

Apple provides “electronic services” per Regulation 6. The service is from a server that is not in South Africa to a consumer (“recipient”) in South Africa. Apple is not a resident of the Republic. The customer then purchases the music and listens to it and enjoys it in the Republic. The service constitutes an imported service as the Apple server is situated outside South Africa.

In practice it is difficult to determine the location or jurisdiction where the services are consumed. It becomes increasingly difficult when the consumer is a private consumer as it is in a B2C transaction (Fryer, 2014). It is arguable whether the domain name on computer provides sufficient proof of the supplier location (Steyn, 2010). Due to the fact that the server is located in another tax jurisdiction it could attract VAT in that country, thus resulting in double tax (Janse van Rensburg, 2012). Further challenges relating to the place of supply will be discussed in chapter 5. For the purpose of this dissertation it was assumed that the services are consumed in South Africa so this is not a problem, however this needs to be considered as it has a direct effect on efficiency of the VAT registration.

4.3.5 VALUE OF SUPPLY

Section 14(5)(e) provides that VAT does not have to be accounted for in terms of Section 7(1)(c) for e-commerce services where the supply is below R100 per invoice (“de minimus rule”); however, to the extent that VAT is levied under Section 7(1)(a)

the de minimus rule does not apply to e-commerce services (VAT Act). This means that smaller transactions, i.e. the purchase of music from online stores will be subject to VAT at 14% (Louw & Botha, 2014) if the vendor was required to be registered and levied VAT in terms of section 7(1)(a).

It may be difficult to administer the collection of VAT for transactions below R100 however collectively these transactions could result in millions of Rand of lost VAT revenue.

As Apple is a vendor (or assumed to be one) s 7(1)(a) applies and consequently the R 100 limit is not applicable.

4.4 CHALLENGES IDENTIFIED

When dealing with the above transaction the tax laws may apply; however, there may be administrative challenges that arise once the legislation applies to certain transactions. These challenges will be identified below.

4.4.1 DETERMINATION OF EXTENT OF THE ACTIVITIES

A challenge that may arise from a SARS perspective is how SARS will determine the extent of B2C services or transactions. This will be discussed in chapter 5.

4.4.2 DOCUMENTATION

The issue with the above type of transaction is that it has a paperless trail. Documentation creates a challenge for the tax authorities and the vendor. On the one hand it creates an administrative burden on the vendor and it has a direct impact on how practical and efficient it is to collate the required documentation, on the other hand the effectiveness of the process is affected by the fact that the consumer's details are not always valid. Apple would have a significant challenge when it comes to complying with all the administrative requirements regarding the VAT on e-commerce transactions. The compliance burden has a direct impact on how practical, effective and efficient it is to have this VAT legislation. SARS may encounter issues around documentation. This will be discussed in chapter 5.

4.4.3 CENTRALISED TAX ADMINISTRATION FRAMEWORK

In the above case study Apple would have a significant administrative burden as it would have to comply with not just the South African VAT legislation on e-commerce services but all the other countries that have similar laws. As mentioned in par 3.5 Apple has about 800 million itunes accounts. This would be inefficient as each country has its own tax administration processes, and there is no centralised tax administration framework. This will be discussed in chapter 5.

4.4.4 ENFORCEMENT OF TAX LAWS

The administration will face challenges when it comes to enforcing collection and compliance with tax legislation when dealing with FESEs. This will be a measure of whether the tax laws are effective. This will be discussed in chapter 5.

4.5 CONCLUSION

As could be derived from the consideration in this chapter, there is a **supply by a vendor of services** in the course or furtherance of an **enterprise** in terms of Section 7(1)(a) and there is a **supply of imported services** in terms of Section 7(1)(c). It could be concluded that, based on the facts considered above, VAT has to be imposed on the transactions between Apple and the South African consumer in terms of Section 7(1)(a) or (c). As Apple complies with all the requirements of Section 7(1)(a) to be a registered vendor, only Section 7(1)(a) will be applicable to e-commerce transactions entered into by Apple and the South African consumer.

The application of the new regulations and definitions on e-commerce transactions creates a situation that these services provided by Apple are indeed subject to VAT. As a result Apple would have been required to register as a VAT vendor in South Africa as soon as the total taxable supplies exceeded R50 000 at the end of any month, which could be assumed was already the case. SARS would be required to enforce the law and collect the VAT revenue from Apple.

This chapter addressed the secondary research objective as identified in par. 1.4.2 (iii) and established in order to create a framework to assess the practical, effective, efficiency of the South African VAT Act the VAT Act would have to apply to the scenario. In the next chapter the challenges created by e-commerce transactions will be discussed.

CHAPTER 5: CONSIDERATION OF THE DEFICIENCIES NOTED IN THE APPLICATION OF THE LEGISLATION

5.1 INTRODUCTION

The fourth secondary objective as identified in par. 1.4.2 (iv) is to consider the challenges of the e-commerce environment and the deficiencies noted in the South African implementation of e-commerce legislation and will be addressed in this chapter. South Africa is not the first country to legislate the taxation of e-commerce services, where applicable references will be made to the OECD and the challenges noted at an international level, which will further substantiate the arguments made in this dissertation. The deficiencies noted in this chapter will further assist in determining whether or not the VAT legislation is practical, effective and efficient. This will address the research objective as identified.

The deficiencies that are noted in the VAT system arise as a result of the difficulties or challenges that the e-commerce environment poses for existing international tax rules and for the purpose of this dissertation the challenges posed to VAT rules. This chapter will now explore those challenges.

The following challenges were identified in chapter 2 and 4 relating to e-commerce transactions and will be considered in this chapter. These challenges have an effect on the practicality, effectiveness and efficiency of the VAT legislation on e-commerce transactions:

- Determination of the extent of the activities
- Documentation
- Enforcement of tax laws
- VAT threshold and registration
- Burden of compliance
- Enterprise
- Place of consumption

5.1.1 DEFICIENCIES OR CONCERNS IDENTIFIED

E-commerce transactions create numerous challenges for policy-makers, extending beyond tax to international and domestic law, data protection, accounting and other regulation (OECD, 2014:55). In the first interim report of the Davis Tax Committee (2014) it was stated that e-commerce transactions do not have geographical boundaries. According to Patel (2014), a firm may conduct business in one country to another country and not have physical presence in the other country. This creates uncertainties as to where the tax obligation lies. The increase in e-commerce transactions with reduced physical presence raises the question of whether traditional rules are sufficient and adequate to address these challenges (OECD, 2014:56). According to Hanefah, Hassan and Othman (2008), online businesses may no longer be bound by the same legal framework and regulatory procedures as their traditional counter parts. For many years companies and individuals have contributed to public expenses through the payment of tax. The development of e-commerce transactions enables key contributors to the tax base to find ways to operate their businesses to avoid, reduce or remove their tax liability. This has the potential to put the tax burden on only a few remaining taxpayers (OECD, 2014:55).

In the South African context the same difficulties are experienced by policy-makers. Companies like Apple operate from remote locations without physical presence in South Africa and as seen in previous chapters the authorities have adapted the legislation in order to try to regulate these e-commerce activities. SARS has applied various methods to determine whether or not the tax obligation lies in South Africa, for example changing the definition of an enterprise thus ensuring that the foreign suppliers pay their fair share of taxes in South Africa. As a result the tax burden will be more equitably distributed amongst all potential taxpayers.

5.1.2 DETERMINATION OF THE EXTENT OF ACTIVITIES

A challenge as identified in 4.4.1 for local tax authorities is to determine the extent of the business activities on online platforms with limited access to information (i.e. accounting records, bank statements etc.) on the foreign supplier (OECD, 2014:62). Third parties such as the customer, banks and other intermediaries may be

approached however they may be subject to privacy laws and financial regulation laws (OECD, 2014:62).

Legislation without proper implementation is ineffective. A deficiency noted in the South African legislation would be how the authorities would determine the extent of e-commerce transactions taking place that fall within the ambit of South African law. This is an issue that other international tax bodies are grappling with. In order to regulate the new rules on e-commerce transactions some thought should be given to how to quantify the transactions so as to determine the number of taxpayers liable for VAT and the extent of VAT revenue that should be collected. A proper method to identify these transactions should be determined by all the role players both in the Republic and internationally.

5.1.3 DOCUMENTATION

As identified in par 4.2.2 the documentation creates a challenge for the tax authorities and the vendor. On the one hand it creates an administrative burden on the vendor and it has a direct impact on how practical and efficient it is to collate the required documentation, on the other hand the effectiveness of the process is affected by the fact that the consumer's details are not always valid.

According to Patel (2014) a tax invoice is the primary instrument for a transaction that is liable for VAT. According to Du Plessis (2006), historically transactions were entered into and the relevant source documentation was provided with the date, parties involved, value of transactions etc. This left evidence of the transaction. The issue with e-commerce transactions is that they have a paperless trail. That creates a challenge for tax authorities as these transactions are not easily traceable (Rosenberg, 2008). Akcaoglu (cited by Fryer, 2014) states that e-commerce transactions have an anonymous character in contrast to the traditional ways of commerce. As no audit trail is left behind it becomes increasingly difficult for authorities to check compliance (Patel, 2014).

As a limitation of this study it was decided that there would be a focus on B2C transactions. B2C e-commerce transactions pose a significant challenge as obtaining information from private and unregistered consumers is extremely difficult (Patel,

2014). Many consumers are reluctant to include unnecessary personal information on websites, they resort to either not including this information or falsifying the information to get over the required steps of the transaction (Jones & Basu, 2002). This may result in an inability to tax these transaction resulting in base erosion (Jones & Basu, 2002). According to Cohen (cited by Fryer, 2014) documentation is often forged and the true origin of a transaction may be difficult to establish. The challenge posed by e-commerce transactions is that the documentation that may be obtained in the e-commerce environment may not be robust (Du Plessis, 2006). Electronic documentation may be altered thus making it difficult to be relied upon. Paper documentation may also be altered, but often evidence of its alteration may be left (Du Plessis, 2006). The Vendor is required to comply with the administrative requirements of each country that the vendor operates in and the requirements of a proper invoice, this has a direct impact on how practical, effective and efficient it is to do so.

It is evident from the above that the documentation retrieved from e-commerce transactions needs to be authenticated. There is a significant risk that the documentation may be altered by customers and suppliers. As seen in the case study and par 3.7 Apple relies on the consumer to provide them with accurate information however customers and suppliers could alter their information to pay less VAT. An electronic VAT audit would have to be conducted by SARS and that is not without its own challenges. A question is raised as to whether SARS is equipped to address these challenges? Does SARS have the necessary resources to track the foreign suppliers and conduct audits of their transactions? This remains to be seen. This is pertinent information required by SARS in order to determine the place of supply and the relevant tax legislation that is applicable to the transaction. This remains a challenge for SARS. Without the ability to verify the relevant documentation presented by the taxpayer it could render the laws enacted on e-commerce transactions ineffective. This has a direct effect on whether the theory is practical. It appears that the theory alone is not suitable to address the practical effect of this legislation. The theory may also not be effective as it does not always create the desired result.

5.1.4 CENTRALISED TAX ADMINISTRATION FRAMEWORK

A challenge identified in par 4.4.3 is that there is no centralised tax administrative framework. There is currently no international framework that allows small or large

business to register for consumption taxes and manage payments to more than one revenue authority (OECD, 2014:55). According to Hanefah *et al.* (2008), a challenge created by e-commerce is inconsistent tax systems across borders. The fact that these companies have to manage a large number of small transactions could result in an administrative burden to the taxpayer yielding very little tax revenue (OECD, 2014:55). The cost of the exercise may outweigh the benefit and encourage non-compliance (OECD, 2014:55). As mentioned in par 3.7 Apple has 800 million iTunes accounts and the company deals with a large number of small transactions, which results in a massive administrative burden which has a direct impact on the efficiency of the VAT system.

The broad taxation principles which should apply to electronic commerce, as identified in the Taxation Framework Conditions, were considered in Chapter 2. Efficiency and simplicity were some of the fundamental principles considered and it emerged to be an important theme in consumption tax on e-commerce services. The lack of an international framework that allows for businesses to manage payments to more than one revenue body has an impact on whether the laws promulgated in South Africa would result in a simple and effective way of collecting tax. It could be burdensome to foreign suppliers, resulting in more of the foreign supplier's resources being utilised to meet their tax obligations. This is an unintended consequence that results from the legislation on e-commerce transactions. It is a challenge in the South African tax authorities and its international counterparts. Therefore it seems that the system as applied does not comply with the principle of efficiency as it creates an administrative burden on the vendor.

5.1.5 EXEMPTION FOR IMPORTS OF LOW VALUED GOODS OR SERVICES

Many VAT jurisdictions, including South Africa, treat the import of low value items as exempt. In South Africa it is the *de minimus* rule as was discussed in par 4.3.54. Due to the large volumes of e-commerce transactions it becomes increasingly difficult to enforce VAT payment on such small transactions. The value of the threshold for exempt imports differs from country to country (OECD, 2014:59).

- The exemption could result in businesses structuring their transactions in such a way that it remains below the required threshold thus not being liable for VAT (OECD, 2014:59).
- The exemption could result in loss of tax revenue from the services and disadvantages the local service providers as they will be required to pay tax on similar transactions. This could be an incentive for local supplier to relocate their businesses offshore to avoid tax, this will have an impact on direct taxes and local employment (OECD, 2014:59).

At the time when most of these thresholds were determined, e-commerce transactions were not as significant as they are today. In recent years many countries have seen an increase in transactions below the various thresholds. A balance needs to be found between revenue protection and the distortion of competition (OECD, 2014:59).

In par 4.3.5 the *de minimus* rule was discussed as it affects the value of supplies, and this rule could affect all the supply of small e-commerce services that could result in a significant loss of revenue. Given the changes that the e-commerce transactions have brought about, it may be time to review the exemption rules, to determine whether these rules are still appropriate for today's environment (OECD, 2014:67). The tax authorities should consider whether their systems could be upgraded in order to deal with these low value transactions, thus allowing the removal of these rules (OECD, 2014:67). Should the *de minimus* rule apply, it could render the South African legislation on e-commerce transactions ineffective as the supply of those transactions could be exempt and the practical application of the theory might not achieve its intended purpose.

It is recommended that the South African tax authorities review the exemption rules and the role it plays in the taxation of e-commerce transactions. In the case study in chapter 4 an assumption was made that all the transactions exceeded the threshold for exempt transactions in order to display how the legislation can be effective in meeting its intended objective, which is to tax e-commerce transactions. The fact that the VAT Act exempts low value e-commerce transactions could be seen as a deficiency in the taxation of e-commerce transaction as these transactions could be reducing the revenue base thus rendering the legislation ineffective.

5.1.6 VAT THRESHOLD AND REGISTRATION

Many VAT jurisdictions apply a VAT threshold. The OECD endorses the use of a VAT threshold in a VAT system. The use of the VAT threshold has been seen to have advantages as it reduces the administrative burden due only to certain taxpayers being required to register for VAT. The tax authorities can focus their resources where they are likely to earn taxes. South Africa's decision to use a threshold is found to be in line with international practices (Davis Committee, 2014:33). In par 2.7 and par 4.3.3 the R50 000 threshold applicable to FESEs was discussed. This is the threshold that applies on FESEs to register as VAT vendors.

In keeping with the principle of a good tax system the South African tax authority must strive to maintain neutrality and competitiveness among all taxpayers (Davis Tax Committee, 2014: 34). The local tax authorities should strive not to have unfair discrimination by applying different rules to foreign suppliers and local suppliers. The mandatory threshold for local suppliers to register for VAT is R1 million (VAT Act) and the threshold applied to FESE's is R50 000 (VAT Act). Many could argue that this is unfair discrimination and is not in keeping with the principle of neutrality. The low registration threshold will result in smaller FESE's being caught in the VAT net most which may not know that the new requirements exist (Palmer, 2014). SARS justified the decision by saying that they are trying to ensure FESEs do not have a competitive edge over local suppliers. The difference in the thresholds is however a cause for concern and should be rectified (Davis Tax Committee, 2014:45). This view is supported by Mahlunge (2014) who states that the aim of the threshold was to "level the playing field" between FESEs and local suppliers.

Is the discrimination unfair? An argument to support the threshold could be that it was implemented to protect local trade; however, the laws must also not discriminate against FESEs. A low registration threshold for FESEs might not be effective as it may not be successful in producing the desired result which is a fair tax system that does not discriminate against foreign taxpayers. When considering the practicality of the R50 000 threshold, one has to wonder whether such a low threshold is suitable for the particular purpose. It could create an administrative burden on the state and the taxpayer. It might not be the most efficient way to collect taxes from an administrative point of view due to the sheer volumes of taxpayers that need to comply with this

legislation. This deficiency in the South African VAT threshold should be reviewed by the tax authorities.

5.1.7 BURDEN OF COMPLIANCE

According to the Davis Committee (2014) there is an administrative burden on FESEs as they are required to file a monthly VAT 201 return. In addition to this, FESEs would need to modify their systems to ensure that it complies with the South African VAT requirements and the requirements of the other jurisdictions they do business with. The EU VAT directive has similar VAT invoice requirements to the South Africa VAT Act. The invoice is to be expressed in Rand displaying the VAT charge. This is supported by Mahlunge (2014) who states that the compliance burden experienced by FESEs should be kept low and there could be a significant compliance burden on FESEs if they are required to comply with stringent VAT compliance requirements.

Further challenges that are created by the VAT legislation are as follows:

FESEs are required to transfer funds from a foreign bank account into the SARS bank account. The jurisdiction within which the FESE operates could have stringent exchange controls which could also add to the taxpayer's administrative burden and take time to implement. Should the VAT payments not be made timeously this could result in SARS charging late penalties and interest. The VAT Act requires that records be kept in South Africa unless specific requirements are adhered to. This goes against the practice in the EU which allows records to be kept in a cloud and that the authorities be granted access when required. VAT branch registration requires the branch to maintain its own accounting system. This could be extremely burdensome (Davis tax Committee, 2014:47).

The above results in an increased compliance burden for the FESEs, as a result the maximum productivity will not be met with minimum wasted effort as stated in the definition of efficiency in par 1.3. The cost effectiveness of collating the tax information and the administrative burden will have to be considered. As stated in par 2.8.3.2 efficiency is a fundamental principle in taxation. This increased burden goes against the principles of simplicity and efficiency as discussed in par 2.8.3.2 and 2.8.3.4.

5.1.8 ENFORCEMENT OF TAX LAWS

In par 2.5 and par 2.6 the South African tax legislation on e-commerce transactions was considered. The case study applied the legislation and a challenge was identified in par 4.4.4. From this it was noted that the administration will face challenges when it comes to enforcing collection and compliance with tax legislation (Azam, 2007). How would one follow up enforcement actions, such as tax audits, requests for additional information, reviewing of accounting records and collection procedures in the case of non-compliance (OECD, 2014:62)? Pertinent questions arise that create challenges with the enforcement of the legislation. Will SARS have a legal right to investigate or audit the FESEs? Is SARS prepared to handle the additional administrative burden created by the legislation and the audits?

The increase in the number of transactions that occurs over the internet will pose a huge challenge to SARS' administrative capabilities. The problems that SARS may face are as follows:

- Monitoring of the flows of money from the e-commerce transactions;
- Verifying and ensuring compliance of vendors;
- Regulating the supply of e-commerce transactions; and
- Keeping accurate records and verifying that the e-commerce transactions have taken place (Bagraim, 2001).

The difficulties in the administration of e-commerce transactions could result in erosion of the South African tax base (Steyn & Van Zyl, 2010).

From the above it is clear that it is important to implement an effective and efficient compliance and collection administration in order to protect leaks or erosion of the tax base.

The reverse charge mechanism is used as a way to collect taxes on imports from non-registered foreign suppliers who do not exceed the R50 000 registration threshold in terms of section 7(1)(c) of the VAT Act. The consumer has 30 days in which to furnish the declaration and make payment to the revenue authorities (VAT Act). The reverse charge mechanism puts the obligation on the purchaser to furnish the necessary

documents to SARS. The onus is on the consumer to pay VAT on imported services (Botha & Louw, 2014). According to research conducted by the Digital Media and Marketing Association, 39% of South African adults have access to the internet. In 2013 there were 14 million internet users and some of those purchased goods online possibly from foreign service providers. This creates an administrative burden for SARS to ensure all the South African consumers comply with the VAT laws. The consumer is often not aware that they are required to furnish documents to SARS for their online purchases (Botha & Louw, 2014). The amounts payable by each consumer are often small and this could lead to increased numbers of declarations (Steyn & Van Zyl, 2010). This method of collecting VAT on electronic services provided by foreign suppliers has low compliance levels and is difficult to enforce due to the large volumes of consumers (KPMG, 2013). The advantage of this collection mechanism was that it was effective for collection of Business to Business (B-2-B) transactions as they are known to the revenue authorities and their accounting records are subject to audits by SARS. According to Doernberg and Hinnekens (cited by Steyn & Van Zyl, 2010) this is, however, not effective for businesses that are not registered as well as for private customers.

The OECD recommends that VAT authorities enact a simple registration process for non-resident suppliers (Steyn & Van Zyl, 2010). In par 2.7 the registration process of a FESE in South Africa was discussed and it was determined that this process was implemented in order to simplify the registration process. The enforcement of the legislation remains a significant challenge. This requires cooperation from the international community and the FESEs (Davis Tax Committee, 2014:47). It becomes increasingly important that bilateral agreements, multinational treaties and mutual assistance agreements be signed to ensure cooperation (Davis Tax Committee, 2014:49).

It has been recommended to refer to the double tax treaties with other jurisdictions, look into the exchange of information agreements etc. The Council of Europe and the OECD jointly developed the Mutual Administrative Assistance in Tax Matters in 1988 amended by Protocol in 2010 (OECD, 2015a). This convention covers VAT matters and it promotes international cooperation and its aim is to tackle tax avoidance and evasion (OECD, 2014:62).

As at 4 June 2015 there were 61 signatories of the multilateral competent authority agreement and the intended first information exchange date was stipulated (OECD, 2015b). South Africa is one of the signatories of this agreement (OECD, 2015b). This will assist SARS with enforcing the tax laws on e-commerce transactions. The intended first exchange of information is intended to be by 17 September 2017 (OECD, 2015b).

From the above it is noted there is a major concern that the legislation might not be enforceable which has a direct impact on whether it is practical, effective and efficient. If the legislation cannot be enforced then it is theoretical and can't be applied, thus it does not meet the definition of practical which was discussed in par 1.3 and it is not "suitable for a particular purpose". In par 1.3 effective was defined as "successful in producing a desired or intended result". Should SARS not be in a position to enforce the legislation it then does not meet the intended purpose thus rendering it ineffective. The enforcement of the legislation must be done in the most efficient manner ensuring that a cost versus benefit analysis is performed. In par 1.3 and par 2.8.3.2 efficiency is defined as a fundamental principle of a good tax system. The recommendation made to the tax authorities is to ensure the above concerns are addressed.

5.1.9 PLACE OF CONSUMPTION AND IDENTIFICATION OF CUSTOMERS

By international standards and the guidelines set out by the OECD it has been determined that VAT or consumption taxes should be incurred in the jurisdiction where the consumption takes place (OECD, 2014). The "source based principle" or the "territorial jurisdiction" allows the source country to tax non-residents on income incurred within its borders (Coertse, 2012:31).

VAT systems should be built in a way that enables them to identify the place of consumption or have place of supply rules (OECD, 2015). According to De Koker and Kruger (2010) the VAT Act does not provide for place of supply rules. De Koker and Kruger's view was supported by Bardopoulos (2012:157) who stated that there was a lack of *place of supply rules* in the VAT Act in South Africa. The Davis Tax Committee, (2014:39), however, found that the new definition of "enterprise" when read in conjunction with the definition of electronic services achieves a deemed place of supply from a South African perspective.

From the above it is clear that it becomes important that the tax authorities clarify the place of consumption rules as only the definition of an enterprise achieves a deemed place of supply. Apple as the vendor would be required to identify where the goods or services are consumed or deemed to be consumed, as this is the place where VAT is to be paid. It may be increasingly difficult to locate the place of consumption when an intangible service is supplied. The OECD has guidelines on the place of taxation of B2C supplies of intangible assets. When implementing the place of consumption rules, principles of a good tax system should always be applied. A burden is placed on the vendor to determine the correct place of consumption rules. As discussed in par 4.3.4 for the purposes of this dissertation it was assumed that the services are consumed in South Africa so this is not a problem, however this needs to be considered as it has a direct effect on the efficiency of the VAT registration. As mentioned in par 3.5 Apple has about 800 million iTunes accounts. It would be inefficient as each country has its own tax administrative processes, there is no centralised tax administration framework. This is a global challenge, not only applicable to South Africa's VAT system.

For the effective application and enforcement of the legislation on e-commerce transactions, SARS is required to identify the parties to the e-commerce transaction. With reference to the case study in chapter 4, SARS is required to identify the supplier (Apple) and the customer. According to Pinto (1999) it is essential to ascertain the parties to e-commerce transactions. For VAT on e-commerce transactions to be effective, the foreign supplier needs to be able to identify the location of the customer where consumption occurs (OECD, 2014:62). The foreign supplier relies on the customer not to disguise their location (OECD, 2014:62).

Based on discussions in Chapter 2, to carry on an enterprise in South Africa when the supply of electronic services is by a person from a place in an export country, the customer must be a South African resident or the payment to the supplier has to emanate from a bank registered within the Republic in terms of the Banks Act.

SARS needs to establish the following:

- that the supplier is in an export country;
- the customer is a South African Resident; or

- payment originates from a bank within the Republic.

An assumption is made by the tax authorities that the FESE can identify the consumer's location. The Davis Tax Committee (2014:49) identifies six methods that the FESEs could use to identify the customers place of supply namely:

Method identified by the Davis Committee	Possible weaknesses Identified
Customer self-declaration	This relies on the integrity of the customer. Taxpayers are known to manipulate information to best suit their taxing needs.
Billing information	This information is supplied by the customer. These services are capable of electronic delivery, the customer can submit false billing information to escape VAT.
Tracking/Geo-location software	This software is expensive and can be circumvented by anonymising software. Furthermore, accuracy levels are low.
IP address	The IP address of the device on which the purchases are made: Multiple devices can share the same IP address. The IP address can be hidden by use of anonymising software.
Tracing the payment path	Due to privacy protocol, financial institutions no longer reveal customer information to suppliers. Furthermore, credit card numbers can no longer be used to verify the country of issue with accuracy.
Digital certificates	Very few countries issue taxpayers with individual digital tax certificates.

Different authors have suggested different methods of obtaining information, i.e. electronic audit logs, database technology to track tax rates by jurisdiction, encryption and authentication tools to ensure that buyers and sellers don't deny their involvement in these transactions (Rosenberg, 2008). The OECD has done extensive work on ways to identify the residents of e-commerce customers and thus determining the place of consumption, these include self-declaration, credit card billing address, IP traces and digital certificates (Pronina, 2011:36).

From the above it is clear that it becomes important that the tax authorities clarify the place of consumption rules as only the definition of an enterprise achieves a deemed place of supply. One of the challenges that still exist is identifying the real location of the customer. If the place of supply cannot be identified then it may affect whether the legislation is practical, effective and efficient. If the legislation cannot be identified then it is theoretical and can't be applied, thus it does not meet the definition of practical which was discussed in par 1.3 is not "suitable for a particular purpose". In par 1.3 *effective* was defined as "successful in producing a desired or intended result". Should the vendor not be in a position to identify that the place of consumption is South Africa, the legislation then does not meet the intended purpose, thus rendering it ineffective. The identification of the place of consumption must be done in the most efficient manner ensuring that a cost versus benefit analysis is performed. In par 1.3 and par 2.8.3.2 efficiency is defined a fundamental principle of a good tax system. The recommendation made to the tax authorities is to ensure that the above concerns are addressed and the place of consumption rules are clarified.

5.2 PRINCIPLES OF A GOOD TAX SYSTEM

In par 2.8.3 the principles of a good tax system were discussed. It was noted that it is imperative that tax authorities across the world adopt VAT provisions that do not result in double taxation in another jurisdiction (Davis Committee, 2014:32). The main objective of this dissertation is to ascertain whether the current VAT provisions are practical, effective and efficient to implement on electronic services taking place in South Africa. The practicality, effectiveness and efficiency of the tax legislation on electronic services have been evaluated throughout chapter 5. As mentioned in par 2.8.3 there are additional principles that determine whether or not the legislation is aligned to these principles are neutrality, certainty, simplicity and flexibility.

From the above challenges that have been identified in par 5.2.5 it can be noted that the principle of neutrality which states that taxation should be unprejudiced or unbiased to all taxpayers is not adhered to. The mandatory threshold for local suppliers to register for VAT is R1 million (VAT Act) and the foreign suppliers threshold is R50 000 (VAT Act). The higher registration threshold seems to favour local taxpayers. The tax authorities would need to review the thresholds between the local and foreign taxpayers.

According to Rendahl (2009) it is important to consider certainty and simplicity when drafting legislation. As discussed in par 5.2.6-8 there is a lot of uncertainty as to how the legislation will be enforced, whether it will create a burden of compliance on the FESEs and the place of consumption rules. This uncertainty will make it difficult for the taxpayer to apply the legislation and for the tax authorities to enforce the legislation. This will not be in line with the principles of a good tax system of certainty and simplicity discussed in par 2.8.3.3 and par 2.8.3.4.

As discussed in par 2.8.3.6 tax should not be rigid and should evolve with the environments of operation. It should keep abreast of technological and commercial developments (OECD, 2001). Flexibility is fundamental for the taxation of e-commerce. Flexibility could then also involve legislation coping with an ongoing development in society (Rendahl, 2009). The adoption of the legislation on electronic services creates an impression that the tax authorities are trying to evolve with the changing business environment. There has been an attempt to curb the tax leakage that results from these kinds of transactions. The tax authorities have thus attempted to be flexible and as discussed above this is not without its challenges. According to Mahlunge (2014) SARS has upgraded their systems in order to accommodate the registration of the FESEs thus proving they are not rigid and they are evolving with the business environment.

5.3 CONCLUSION

There are major challenges that affect South Africa and the international community when it comes to regulating e-commerce transactions. The OECD and EU have done extensive work on the challenges that this environment creates and it can be noted that the challenges identified are not unique to South Africa.

It is imperative that the approach taken to tax e-commerce transactions be fair, simple and efficient. This mini-dissertation has evaluated whether the tax legislation on e-commerce transactions is practical, effective and efficient.

As seen from the evaluation of the factors in this chapter it was determined that firstly a challenge exists in determining the extent of the activities in an e-commerce environment. The tax authorities can't effectively implement tax laws if they cannot identify the extent of the problem that they are confronted with. It makes it difficult to quantify the revenue that should be collected versus the revenue that has already been collected.

A second challenge is obtaining the documentation that is the basis of VAT transactions and verifying the authenticity of such documentation. E-commerce transactions leave very little audit trail. This may prove to be challenging for authorities.

A third challenge that was identified in par 4.3.4 is that there is no centralised administration framework that allows FESEs to register for consumption taxes and manage payments to more than one revenue authority. The compliance with various tax authorities could be a huge administrative burden for the FESE. This is further intensified by the reporting and payment requirements that FESEs have to adhere to.

The fourth challenge that arises is the relevance of the exemption of low value imports of goods or services. Cumulatively these exempt services could result in lost revenue. Tax authorities should consider their relevance in the e-commerce environment and whether or not the revenue collection systems can be upgraded to ensure it can cope with the administration of these transactions.

A deficiency noted in the current mandatory registration threshold for local suppliers is R1 million (VAT Act) in contrast to the foreign suppliers threshold that is R50 000 (VAT Act). Many could argue that this is unfair discrimination and is not in keeping with the principle of neutrality.

The next challenge would be the enforcement of tax laws, in a case of non-compliance. How will the tax authorities follow up on enforcement actions such as tax audits, requests for additional information, reviewing of accounting records and collection

procedures? This remains a significant challenge as an efficient and effective law is measured by whether it can be enforced.

The discussion in this chapter has identified the challenges that lead to deficiencies in the application of the VAT legislation on e-commerce. International bodies have done extensive research into the challenges that plague the taxation of e-commerce transactions. Similar challenges have been noted in the South African VAT system. The effective implementation of the VAT legislation is measured on the South African authorities' ability to tackle these challenges and identify solutions to them.

In this chapter the secondary objective of this mini-dissertation as identified in 1.4.2 (iv) was addressed by considering the challenges identified by the study and how it affects the practicality, effectiveness and efficiency of the tax legislation on e-commerce transactions. Chapter 6 will summarise and make conclusions on the findings of the study with regards to the practicality, effectiveness and efficiency of South African VAT on e-commerce services and to provide recommendations to SARS based on the findings of the study.

CHAPTER 6: SUMMARY, CONCLUSION AND RECOMMENDATIONS

6.1 INTRODUCTION

The fifth secondary objective of the dissertation, as identified in par 1.4.2(v) is to summarise and conclude on the findings of the study with regards to the practicality, effectiveness and efficiency of the South African VAT legislation on e-commerce services and to provide recommendations to SARS based on the findings of the study. This objective will be addressed in this final chapter.

6.2 BACKGROUND OF RESEARCH

The research found that there has been an international trend among revenue authorities to identify ways to tax e-commerce transactions. South Africa has made changes to its VAT legislation in line with international trends in an attempt to ensure that e-commerce transactions are subjected to tax and base erosion is limited as far as possible.

The National Treasury issued regulations in January 2014 that define “electronic services”. These regulations are known as the Electronic Services Regulations (the Regulations) and detail which digital products and services will be subject to the 14% VAT when the Regulations were to come into operation on 1 April 2014 (Department of National Treasury, 2014). The effective date was later moved to 1 June 2014 (Department of National Treasury, 2014).

The main objective of this study as set out in Chapter 1 par 1.4.1 was to ascertain whether the current VAT provisions are efficient and effective to be successfully and practically implemented on electronic services supplied by a non-resident in South Africa. This main objective was addressed by four secondary objectives which were discussed in each individual chapter.

In chapter 1 par 1.3 the definitions of practical, effective and efficient were provided as follows:

The *Oxford Dictionary* (2015) defines the word *practical* as “of or concerned with the actual doing or use of something rather than with theory and ideas” and “suitable for

a particular purpose”. The question arises whether or not the theory contained in the legislation is suitable for a purpose or it remains a theory or an idea.

The *Oxford Dictionary* (2015) defines the word *effective* as “successful in producing a desired or intended result”. The research question was answered by determining whether the VAT legislation on e-commerce transactions could be successful in producing the desired result.

The *Oxford Dictionary* (2015) defines the word *efficient* as “achieving maximum productivity with minimum wasted effort or expense”. The OECD (2014) states that “in order to ensure efficiency it is important that the administrative burden that tax rules impose on taxpayers and administrations should be minimised as far as possible”.

6.3. LIMITATIONS OF THE STUDY

The Regulations prescribing electronic services for the purpose of the definition of “electronic services” in Section 1(1) of the Value-Added Tax Act (89 of 1991) (VAT Act) defines electronic services and lists items that fall within the definition. For the purpose of this study, only regulation 6 dealing with miscellaneous services was considered which lists the supply of e-books, film, music, images and software. E-books include electronic publications. Films include movies, video clips etc. Music includes audioclips, songs and jingles. Images include photographic material etc. (South Africa, 2014:5:6).

6.4 SECONDARY OBJECTIVES

6.4.1 FIRST SECONDARY OBJECTIVE

The objective is to consider and interpreted the South African VAT legal framework on e-commerce transactions provided by foreign companies in South Africa and provided insight into the application of this legislation. International guidelines on indirect taxes on e-commerce or electronic services were briefly considered.

The research obtained an understanding of the South African VAT legislation. E-commerce transactions do not always create a PE establishment and as result

direct tax principles may not apply and as a result in accordance with international trends South Africa has focused on taxing e-commerce transactions using indirect tax.

VAT was determined to be an important revenue source for the National Treasury accounting for about 26.4% of the tax revenue base. It was concluded that it was imperative for the VAT legislation to be practical, effective and efficient in achieving its intended objective so as not to compromise the revenue base in the future.

It was noted that for the imposition of VAT there had to be a supply of goods and services by a vendor during the furtherance of an enterprise or the importation of goods or importation of services by any person.

Bardopoulos (2012:57) determined that the definition of e-commerce transactions does not have one definition that encompasses all its attributes.

The Draft Taxation Law Amendment Bill (“DTLAB”) 2013 defined E-commerce as “*The supply of any services where the placing of an order and delivery of those services is made electronically*”.

Due to the uncertainty of the specific services included in the definition amendments were made in 2014. Section 1 of the VAT Act defined “electronic services” as “services prescribed by the Minister by regulation in terms of this Act”. The Regulation provides a list of services that constitute electronic services.

6.4.2 SECOND SECONDARY OBJECTIVE

The second secondary objective is to outline the selection of the service that would be the focus of the case study from the Regulations prescribing electronic services for the purpose of the definition of “electronic services”. A description of the selected Apple iTunes service provided to the customers will be examined. It was also noted in the consideration of the limitations of the study.

As mentioned in par 6.3 for the purpose of this study, only regulation 6 dealing with miscellaneous services was investigated. As mentioned in par. 1.1.1 Apple iTunes is one of the leading media player software applications in the world. Apple was selected

as the main focus of the case study as the services rendered by Apple fell within the definition of regulation 6 miscellaneous services.

6.4.3 THIRD SECONDARY OBJECTIVE

Chapter 4 addressed the third secondary objective which was to use a case study as an explanatory tool. A business transaction was profiled. The South African VAT legislation on e-commerce was applied to the electronic services rendered by Apple iTunes. The legislation that applies to e-commerce services conducted by Apple was listed; however, there were challenges noted in the practical application of the legislation. These challenges noted in the application of the case study were identified. This information formed the basis of the evaluation of the practicality, effectiveness and efficiency of the tax legislation affecting e-commerce transactions.

The following challenges were identified:

- There will be difficulty for SARS to determine the volume of the activities for B2C transactions.
- The issue with the above type of transaction is that it is often undocumented. Documentation creates a challenge for the tax authorities and the vendor.
- There is no internationally accepted centralised tax administration framework for all the countries that the FESE would operate in, as a result an administrative burden is created for the vendor.
- SARS will encounter challenges with enforcement of tax laws as they do not have authority in the other tax jurisdictions.

6.4.4 FOURTH SECONDARY OBJECTIVE

The fourth secondary objective was to consider the challenges of the e-commerce environment and the deficiencies noted in the South African implementation of e-commerce legislation regarding the practical, effective and efficient application of the system. South Africa is not the first country to legislate the taxation of e-commerce services, where applicable references were made to the OECD and the challenges noted at an international level that were used to further substantiate the arguments made in this dissertation.

6.5. OPPORTUNITIES FOR FURTHER STUDY

The following opportunities have been identified as opportunities for further study:

- In chapter 3 par 3.2; the focus of this dissertation was only Regulation 6 dealing with miscellaneous services. The impact of this legislation when applied to the other regulations could be evaluated.
- In chapter 3 par 3.3 of this dissertation a limitation of this study is that it only focuses on B2C transactions, the impact of this legislation on B2B transactions could be evaluated.
- In chapter 4 par 4.3.3 a question was raised on how the small foreign vendors will know that they are required to register for VAT in South Africa? As explained Apple is a large vendor, and as a result this question was not relevant to Apple and therefore out of the scope of this study. However it may well be an aspect worthy of further exploration in a fitting research.

6.6 CONCLUSION AND RECOMMENDATIONS

The practicality, effectiveness and efficiency of the South African legislation on e-commerce transactions was evaluated throughout this dissertation. This will now be considered below.

6.6.1 PRACTICAL

*The Oxford Dictionary (2015) defines the word **practical** as “of or concerned with the actual doing or use of something rather than with theory and ideas” and “suitable for a particular purpose”.* The question arises whether or not the theory contained in the legislation is suitable for a purpose or it remains a theory or idea.

In chapter 4 the theory contained in the VAT act was applied to the e-commerce rendered by Apple iTunes. It was noted that theoretically the transaction met the requirements imposed by section 7(1) (a) of the VAT Act. The supply of music through iTunes constituted a **supply by a vendor** of **services** supplied by him on or after the commencement date in the course or furtherance of any **enterprise** carried on by him. Theoretically the requirements of the VAT Act were met. However, the definition of **practical** specifically states that “of or concerned with the actual doing or use of

something rather than with theory and ideas”. Upon further evaluation practical challenges to the application of the legislation were identified. The following challenges affecting the practical application of the legislation were noted in chapter 5:

- Determination of the extent of the e-commerce transactions that Apple undertakes with customers online;
- The lack of documentation in e-commerce transactions and the inability to ensure validity of the information provided;
- The fact that there is no centralised tax administration framework;
- Exemption for imports of low valued goods or services;
- The low VAT threshold and the registration of FESEs;
- The burden of compliance created on the FESEs as a result of new legislation on e-commerce transactions;
- Enforcement of the tax legislation on e-commerce transactions; and
- Determination of the place of consumption.

Unless these challenges are resolved or reduced significantly, the South African VAT legislation on e-commerce transaction will not be practical.

6.6.2 EFFECTIVE AND EFFICIENT

*The Oxford Dictionary (2015) defines the word **effective** as “successful in producing a desired or intended result”. The research question will be answered by determining whether the VAT legislation on e-commerce transactions will be successful in producing the desired result.*

*The Oxford Dictionary (2015) defines the word **efficient** as “achieving maximum productivity with minimum wasted effort or expense”. The OECD (2014) states that “in order to ensure efficiency it is important that the administrative burden that tax rules impose on taxpayers and administrations should be minimised as far as possible”.*

Legislation without proper implementation is ineffective. As stated in par 4.4.1 and 5.2.1 deficiency noted in the South African legislation would be how the authorities would determine the extent of e-commerce transactions taking place that fall within the ambit of South African law. This is an issue that other international tax bodies are grappling with. In order to regulate the new rules on e-commerce transactions some thought should be given to how to quantify the transactions so as to determine the

number of taxpayers liable for VAT and the extent of VAT revenue that should be collected. It is recommended that a proper method to identify these transactions should be internationally considered.

As identified in par 4.2.2 and 5.2.2 documentation is a significant part of the tax administration process. Documentation in an online environment creates a challenge for the tax authorities and the vendor. On the one hand it creates an administrative burden on the vendor and it has a direct impact on how practical and efficient it is to collate the required documentation, on the other hand the effectiveness of the process is affected by the fact that the consumer's details are not always valid. B2C e-commerce transactions pose a significant challenge as obtaining information from private and unregistered consumers is extremely difficult.

As identified in par 5.2.2 accurate documentation remains a challenge for SARS. Without the ability to verify the relevant documentation presented by the taxpayer it could render the laws enacted on e-commerce transactions ineffective. This has a direct effect on whether the theory is practical. It appears that the theory alone is not suitable to address the practical effect of this legislation. The theory may also not be effective as it does not always create the desired result. SARS should investigate ways to verify and obtain accurate documentation.

As identified in par 5.2.4, should SARS apply the *de minimus rule*, it could render the South African legislation on e-commerce transactions ineffective as the supply of those transactions would be exempt and the practical application of the theory might not achieve its intended purpose. It is recommended that the South African tax authorities review the exemption rules and the role they play in the taxation of e-commerce transactions. In the case study in chapter 4 an assumption was made that all the transactions exceeded the threshold for exempt transactions in order to display how the legislation can be effective in meeting its intended objective, which is to tax e-commerce transactions. It is recommended that the South African tax authorities review the exemption rules and the role it plays in the taxation of e-commerce transactions.

In relation to the enforcement of the legislation as identified in par 5.2.7, should SARS not be in a position to enforce the legislation it then does not meet the intended

purpose thus rendering it ineffective. The enforcement of the legislation must be done in the most efficient manner ensuring that a cost versus benefit analysis is performed. In par 1.3 and 2.8.3.2 efficiency is defined a fundamental principle of a good tax system. South Africa is a signatory to the OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters which came into effect on the 1 March 2014 but will now come into effect in 2017. This is an agreement between countries around the world that is aimed at encouraging co-operation in an effort to tackle tax evasion and avoidance. The parties have an obligation to exchange information (OECD, 2014). The recommendation made to the tax authorities is to ensure that the legislation is enforceable by obtaining assistance from the relevant tax authorities that are signatories to convention of mutual assistance in order to enforce domestic laws.

In par 5.2.8 the challenges relating to the place of consumption were discussed. In relation to the place of consumption rules it is clear that it becomes important that the tax authorities clarify the place of consumption rules as only the definition of enterprise achieves a deemed place of supply. One of the challenges that still exists is identifying the real location of the customer. If the place of supply cannot be identified then it may affect whether the legislation is **practical, effective** and **efficient**. If the legislation cannot be identified then it is theoretical and can't be applied, thus it does not meet the definition of practical. Should the vendor not be in a position to identify that the place of consumption is South Africa the legislation then does not meet the intended purpose thus rendering it ineffective. The identification of the place of consumption must be done in the most efficient manner ensuring that a cost versus benefit analysis is performed. The recommendation made to the tax authorities is to ensure that the above concerns be addressed and the place of consumption rules be clarified.

The VAT legislation will only be effective if it is "successful in producing a desired or intended result" with the identified challenges the desired results may not be achieved. A balance between the cost versus benefit of legislation should be determined from a SARS perspective and from the perspective of the vendor in order for the VAT legislation on e-commerce transactions to be efficient. The administrative burden should be minimised as far as possible.

The dissertation's main objective as identified in par 1.4.1 was to ascertain whether the current VAT provisions are effective and efficient to be successfully and practically

implemented on electronic services supplied by a non-resident in South Africa. Based on the above assessment it can be noted that the current South African VAT legislation in its current form when applied to a real life transaction of the supply of electronic services of a non-resident, Apple iTunes, taking place in South Africa, would be found:

- Not to be practical as SARS would have significant difficulty determining the extent of activities for B2C transactions and SARS would encounter challenges in enforcing the tax legislation on e-commerce transactions as the accuracy of the documentation provided by customers may be questionable.
- To be ineffective as the VAT legislation on e-commerce transactions would not be successful in achieving the desired result if it cannot be enforced.
- To be inefficient if it continues to create an administrative burden of compliance on the FESES where the costs outweigh the benefits.

The challenges noted in this dissertation are addressed. There is no simple resolution to the issues identified as internationally tax authorities are battling to identify ways to overcome the above-mentioned challenges.

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