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Navigating the Digital Age

Tackling the evolving digital economy with direct tax laws

“We are living in a digital age, where individuals and companies can conduct business across borders without moving from their computers”

Article by

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Tackling the evolving digital economy

We are living in a digital age, where individuals and companies can conduct business across borders without moving from their computers. A whole digital economy exists and it would be challenging, if not impossible to ring-fenced it, as the digital economy is increasingly becoming the economy itself. The digital economy in itself does not generate base erosion and profit shifting (BEPS) issues but key features of the digital economy can intensify certain BEPS risks.

Although the digital economy has accelerated the global value chain, some of its features has exposed countries to BEPS, due to a lack of sufficient tax legislation specifically aimed at taxing these electronic transactions. In October 2015, the Organisation for Economic Cooperation and Development (OECD) issued a Report with 15 Action Plans to address BEPS, commencing with Action 1: Addressing the Tax Challenges of the Digital Economy.

Action Plan 1, amongst others, aims to address the ability of a company to have significant digital presence in one jurisdiction without being liable for tax in that jurisdiction. For example, where services are rendered through servers or cloud computing services. This creates complications particularly for the relevant tax authorities who may find it difficult to determine where value has been created by the server and where the tax should be levied.

The OECD has previously attempted to address the taxation issues of electronic commerce, stating in the OECD Commentary on Permanent Establishments that an internet website in itself, which is a combination of software and electronic data does not create tangible property and cannot constitute a "place of business" in terms of the Permanent Establishment definition. The current OECD Commentary that a server on which the website is stored is a piece of equipment with a physical location which may constitute a "fixed place of business" as per the Permanent Establishment definition if the supplier has a server at its disposal.

The problem is, technology has become so advanced, the location of a server can be easily moved between different countries and server programs can be moved almost immediately from one server to another server in a different country. In addition, nowadays, enterprises don't have a single server but multiple servers located all over the world. In applying the current Permanent Establishment principles this could result in a number of jurisdictions claiming they have a taxing right on the profits generated by the server located in their country, while any of these server can be moved to another jurisdiction almost instantaneously by the enterprise if they so choose. This could therefore result in either a double taxation or double non-taxation.

Therefore, addressing the tax challenges in the digital economy, specifically direct taxes, would go hand-in-hand with th**e OECD's Action 7: Preventing the Artificial Avoidance of Permanent Establishment Status.**

One of the potential solutions proposed by the Digital Economy task force to address these challenges is to implement changes to the Permanent Establishment definition. For example, activities that may have previously been considered to be preparatory or auxiliary in nature may in the future be considered to constitute a

Permanent Establishment as they form part of the "core business" of the enterprise.

The task force also proposes the introduction of a withholding tax on sales of digital goods and services. The issue with the introduction of such a withholding tax would be the amendment of a number of Double Tax Agreements. The lack of a specific clause addressing the withholding tax on the sale of digital goods and services in the Treaty would see such profits treated in terms of Article 7 (Business Profits), which would effectively bring you back at square one: determining whether a Permanent Establishment had been created with the rendering of these electronic transactions.

South Africa itself currently has decent legislation in place in the form of section 9D and Section 31 of the Income Tax Act which addresses Controlled Foreign Companies and Transfer Pricing, respectively. These sections and the effective management test all protect the South African fiscus by effectively limiting South African residents from shifting profits to offshore tax havens and to an extent covers electronic transactions.

However, the situation is different where non-residents provide electronic services/goods to South African residents. Non-residents would only be taxed in South Africa on profits that are sourced in South Africa, subject to the relevant Double Tax Treaty. Section 9 of the Income Tax Act addressed the South African source rules, but does not contain rules that specifically address electronic transactions. Even if we consider common law (CIR v Lever Brothers & Unilever Ltd [1946 AD]), which relies on the common principle of originating cause (i.e. what gave rise to the income). Our courts have not considered the question of source with the complexities of the digital economy in mind. A non-resident would for example be able to argue that the originating cause of the electronic transaction is not in South Africa as there is no server located in South Africa, merely the recipient of the transactional goods or services.

We are therefore in agreement with the recommendation made by the Davis Committee aimed at addressing tax issues in the digital economy in South Africa by expanding section 9's source rules to address proceeds derived from the supply of digital goods and services. The Davis Committee recommends that the new rules should be based on where the consumption of the electronic transaction takes place. This would effectively bring electronic transactions provided by non-residents into the South African tax net as it would be deemed to be sourced in South Africa. It would however be interesting to note the wording of these proposed changes to section 9 as a distinction would need to be made between these digital services and physical services. For example the determination of source where an architectural firm in the UK uses digital pathways to send their building plans to South Africa – the physical service is performed in the UK and the product is delivered electronically.

In addition, as the Davis Committee also points out, this inclusion in section 9 would prove to be a balancing act as the country of residence of the supplier where the goods are manufactured would also have a claim to tax a portion of the proceeds. As a result if the full amount of profits is deemed to be sourced in South Africa in terms of Section 9 it could give rise to double taxation.

With the war on BEPS we may see various changes to both local and international direct tax laws that aim to address these digital transactions to address the loss of taxing opportunities and erosion of countries' tax bases. However, with the direct tax challenges highlighted above the question arises: would direct taxes ever be the best option to tackle the taxation of these digital transactions or do we have to accept that a transaction based tax, such as VAT or another consumption tax would be the more suitable answer to addressing tax issues in the digital economy?