

**A COMPARITAVE STUDY OF VALUE ADDED TAX COLLECTION  
METHODS IN THE CONTEXT OF E-COMMERCE AND VIRTUAL WORLDS  
FROM A SOUTH AFRICAN PERSPECTIVE**

by

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*To my wife. Thank you for all your direct and indirect support.*

## **SUMMARY**

# **A COMPARITAVE STUDY OF VALUE ADDED TAX COLLECTION METHODS IN THE CONTEXT OF E-COMMERCE AND VIRTUAL WORLDS FROM A SOUTH AFRICAN PERSPECTIVE**

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E-commerce and transactions in virtual worlds has monetary value and may lead to actual cash flows. Where real money trade occurs tax authorities are bound to seek ways and means in which to levy and collect taxes (Pienaar, 2008:38).

Previous research on the application of the South African income tax laws to transactions in virtual worlds has been conducted. The application of the charging section of the value added tax laws in South Africa has also been researched in the context of e-commerce and transactions in virtual worlds.

Limited research has been conducted on the actual value added tax collection methods in the context of e-commerce and transactions in virtual worlds. This study critically analyses the value added tax collection methods employed in South Africa in the context of e-commerce and transactions in virtual worlds and compares the extent of its application to the extent of the goods and services tax collection methods' application employed in Australia in this context.

The study concludes that that the value added tax collection methods employed in South Africa and the goods and services tax collection methods employed in Australia are similar. Special rules have been adopted in Australia to ensure goods and service taxes are collected on the supply electronic goods. This is not the case in South Africa.

However, in the case of transactions in virtual worlds, both countries' collection methods struggle in ensuring value added tax and goods and service taxes is collected where the supplier of a virtual item is foreign in relation to South Africa or Australia.

## OPSOMMING

# A COMPARITAVE STUDY OF VALUE ADDED TAX COLLECTION METHODS IN THE CONTEXT OF E-COMMERCE AND VIRTUAL WORLDS FROM A SOUTH AFRICAN PERSPECTIVE

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E-commerce en transaksies in virtuele wêrelde het monetêre waarde en mag in sekere omstandighede kontantvloei tot gevolg bring. Wanneer regte geld verhandel word sal belasting owerhede altyd maniere soek om belasting the hef op die onderliggende transaksies en dit in te vorder (Pienaar, 2008:38).

Vorige navorsing rakende die toepassing van die Suid Afrikaanse inkomste belasting wetgewing in virtuele wêrelde is al voorheen gedoen. The toepassing van die heffings artikel in the belasting op toegevoegde waarde (BTW) wetgewing op e-commerce en transaksies in virtuele wêrelde was ook al vorheen nagevors.

Min navorsing was gevind wat alleenlik fokus op die invorderings meganismes in die BTW wetgewing in die konteks van transaksies in virtuele wêrelde en e-commerce. Hierdie studie analiseer krities die toepassing van die invorderings meganismes in die Suid Afrikaanse BTW wetgewing in die konteks van e-commerce en transaksies in virtuele wêrelde en vergelyk die toepassing daarvan met die toepassing van die Australiase *goods and services tax* wetgewing se invorderings meganismes in dieselfde konteks.

Die studie lig uit dat die twee lande se invorderings meganismes baie dieselfde is. The Australiase wetgewing maak egter spesiale voorsiening vir lewerings met betrekking tot e-commerce. Dit is nie die geval in Suid Afrika nie. Met betrekking tot transaksies in

virtuele wêrelde sukkel beide lande se invorerings meganismes om seker maak dat BTW en *goods and services tax* ingevorder word waar die verskaffer nie Suid Afrikaans of Australiaans is nie.

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# **A COMPARITAVE STUDY OF VALUE ADDED TAX COLLECTION METHODS IN THE CONTEXT OF E-COMMERCE AND VIRTUAL WORLDS FROM A SOUTH AFRICAN PERSPECTIVE**

## **CHAPTER 1**

### **INTRODUCTION TO THE STUDY**

#### **1.1 BACKGROUND**

The internet is an ever-growing portal through which trade takes place. From books to cars and almost everything in between can be purchased and sold via the internet. It can literally create a (virtual) world of its own. Linden Lab did exactly this when they created the virtual world called Second Life (Linden Lab, Not dated). According to Camp (2007:3), a virtual world is a graphic representation of reality, which is available over the internet. Inside these virtual worlds, participants or players control an online persona called an avatar (Camp, 2007:3).

In virtual worlds such as Second Life, players can, by instructing their avatar to do so, create virtual goods and sell it to other players' avatars participating in the virtual world (Second Life, Not dated). The medium of exchange in Second Life is a currency known as the Linden Dollar (L\$), a currency which can readily be exchanged for actual United States (US) dollars (US\$) (Second Life, Not dated). As at 16 September 2012, L\$247 buys 1 US\$ (Second Life, not dated).

The real money consequences resulting from trade in virtual worlds such as Second Life has attracted the interest of tax authorities internationally (Pienaar, 2008:38), and researchers alike. Previous research revealed that income earned from virtual world activities may be subject to South African Income Tax (Pienaar, 2008:45). Internationally, research on whether virtual profits can be subjected to income tax in the United States of

America has also been conducted (Lederman, 2007:7). A more recently explored phenomenon in the context of virtual worlds is the application of consumption taxes such as Value Added Tax (hereinafter referred to as "VAT") to transactions in virtual worlds.

Johnston (2011:44) concluded that the South African VAT Act (89 of 1991) (hereinafter referred to as "the VAT Act") does not seem to subject supplies of virtual goods or services to VAT. Hay (2011:38) however concluded differently and states that the VAT Act may require VAT to be levied on supplies made in virtual worlds. The distinguishing factor between the research conducted by Hay and Johnston (referred to above) turns on the definition of an enterprise as defined in section 1 of the VAT Act and whether the supplier is foreign or local.

Similar to supplies of virtual goods or services is the supply of digital goods or services. The supply of digital goods or services relates to the buying and selling of goods and services over the internet or electronic commerce (e-commerce) as defined by Akomolede (2008:2).

Research conducted by De Swardt and Oberholzer (2006:26) on the application of the VAT Act to e-commerce transactions, highlights that the VAT Act does not sufficiently provide for the levying of VAT on the supply of digital goods and services. Van Der Merwe (2003:386) reached a similar conclusion on the same research problem addressed by De Swardt and Oberholzer.

Limited research has been conducted on the effectiveness or application of the VAT collection methods employed in the VAT Act in the context of virtual worlds and e-commerce. The South African VAT Act employs two VAT collection methods. They are the vendor registration method and the self-assessment method (De Swardt and Oberholzer, 2006:23).

The vendor registration method is used to collect VAT where a person carries on an enterprise as defined while the self-assessment method is used where a person imports certain goods or services into the republic. The vendor registration method revolves mainly around whether a person is carrying on an enterprise as defined in section 1 of the VAT

Act. One of the requirements of the vendor registration method that crystalize through the definition of enterprise is that a person is required to carry on an activity in or partly in South Africa. This requirement appears to have different interpretations that support either a place of supply theory or a place of activities theory. This requirement of the vendor registration method may pose a challenge to the South African VAT collection methods in the context of e-commerce and transactions in virtual worlds since supplies occur over the internet.

According to The South African revenue Service (hereinafter referred to as “SARS”) (Not dated:9), revenue from VAT collections contributed 27% to the coffers of the government in the 2011 financial year and was only outdone by personal income tax which contributed 33.7%. If VAT is the second largest contributor of South Africa’s revenue, any potential erosion of this tax base should be a point of major concern.

The Australian equivalent of the South African VAT Act is the New Tax System (Goods and Services Tax) Act 1999 (hereinafter referred to as “the GST Act”). The South African VAT Act and the Australian GST Act are very similar in its requirements and both Acts support a destination based consumption tax system. The GST Act, like its South African counterpart, aims to collect Goods and Services Tax (hereinafter referred to as “GST”) through a registration method and a reverse charge mechanism. These collection methods are similar to the South African vendor registration method and the self-assessment method mentioned above.

This study will critically analyse the VAT collection methods employed in South Africa and apply its requirements to e-commerce and transactions in virtual worlds. The requirements of the South African VAT collection methods will then be compared to the requirements of the Australian GST collection methods and its application in the context of e-commerce and transactions in virtual worlds.

## **1.2 RATIONALE FOR THE STUDY**

Prior research concluded that income earned in virtual worlds may constitute gross income, as defined, in section 1 of the South African Income Tax Act (58 of 1962)

(Pienaar, 2008:45) (hereinafter referred to as “the Income Tax Act”). According to Johnston (2011:44) transactions in virtual worlds should not be subject to VAT because the provisions of section 7(1)(a) of the VAT Act are not wide enough to embrace these transactions. De Swardt and Oberholzer (2006:26) similarly concluded that the VAT Act does not effectively provide for the levying of VAT on the supply of digital goods or services that form the subject of e-commerce. Hay (2011:38) however concluded that VAT may have to be charged on transactions in virtual worlds.

It is hardly contentious that a taxing Act has little effect if the tax it seeks to levy cannot be collected. The two VAT collection methods employed in South Africa were introduced prior to the dawn of e-commerce and transactions in virtual worlds. These transactions accordingly pose some challenges to the South African VAT collection methods.

Since e-commerce and transactions in virtual worlds are inherently international in nature (De Swardt and Oberholzer, 2006:16), the purpose of this study is to compare the extent of application of the South African VAT collection methods in the current context to the extent of the Australian GST Act’s collection methods’ application in the current context.

From an academic point of view, this study will provide valuable insight on some of the international consumption tax issues involved in the context of e-commerce and transactions in virtual worlds.

### **1.3 RESEARCH OBJECTIVES**

The research objectives of this study are:

- to establish a theoretical construct that can be used as underpin in this study by means of a literature review.
- to compare the South African VAT collection methods’ application in the context of e-commerce and transactions in virtual worlds to the Australian GST collection methods’ application in this context.

## 1.4 SCOPE AND LIMITATIONS OF THIS STUDY

This study will be subject to the following delimitations. Firstly, the study will not distinguish between whether any activity carried on in virtual worlds constitutes a hobby or an enterprise. Secondly, this study will only consider the applications of VAT collection methods to unstructured virtual worlds and e-commerce. Lastly, the study does not attempt to establish whether the VAT Act seeks to collect VAT from foreign suppliers only on supplies made by the foreign supplier through a permanent establishment situated in South Africa.

## 1.5 DEFINING THE KEY TERMS

This study contains several key concepts. They are e-commerce, virtual worlds and enterprise. For the purpose of this study, these concepts are defined as follows:

**E-commerce:** Akomolede (2008:2) describes e-commerce as “... the buying and selling of goods and services through the internet.”

**Enterprise:** Section 1 of the VAT Act, in as far as is relevant for the purposes of this study, defines enterprise as: “any enterprise or activity which is carried on continuously or regularly by any person in the Republic or partly in the Republic and in the course or furtherance of which good or services are supplied to any other person for a consideration ...”

**Virtual worlds.** According to Camp (2007:3), virtual worlds are a graphic representation of reality that is made available over the internet.

This study contains the following abbreviations. The meanings thereof are contained in Table 1 below.

Table 1: Abbreviations used in this document

<b>Abbreviation</b>	<b>Meaning</b>
ATO	Australian Taxation Office
GST	Goods and Services Tax
OECD	Organisation for Economic Co-operation and Development
SARS	South African Revenue Service
VAT	Value Added Tax

## **1.6 RESEARCH METHOD**

The study intends to establish, by way of a literature review, the extent of the South African VAT collection methods' application in the context of virtual worlds and e-commerce and to compare its application of the extent of the Australian GST Acts' collection method in the context of e-commerce and virtual worlds.

The chosen enquiry strategy for the study will be literature reviews. Mouton (2001:179) describes this strategy of enquiry as best suited for "studies that provide an overview of scholarships in a certain discipline through an analysis of trends and debates."

This strategy of enquiry is best suited for the proposed study because the problems relating to consumption taxes in the case of electronically supplied goods or services are universal in nature and have been under the inquiring eye of researchers. Research on the issues relating to these supplies follow a specific trend because the international nature of electronically supplied services causes problems relating to which jurisdiction should be allowed to levy and therefore collect consumption taxes.

## **1.7 OVERVIEW OF CHAPTERS**

An overview of the chapters of this study is provided below.

### **1.7.1 Chapter One**

Chapter One of provides the background relevant to the study and sets out the rationale and research objectives of the study. The chapter then sets out the scope and limitations, after which the key terms are defined and the research method selected for the study is briefly explained. Chapter 1 concludes with an overview of the chapters.

### **1.7.2 Chapter Two**

Chapter Two of this study provides a basic understanding of what virtual worlds and e-commerce is. The South African collection methods and its requirements are then identified and applied by means of a literature review to e-commerce and transactions in virtual worlds.

### **1.7.3 Chapter Three**

In Chapter Three, the requirements of the Australian GST collection methods and its application to e-commerce and transactions in virtual worlds are compared to the application of the South African requirements in this context.

### **1.7.4 Chapter Four**

The study concludes in Chapter Four with a summary of findings, scope for future research and concluding remarks.



## CHAPTER 2

### LITERATURE REVIEW

#### 2.1 INTRODUCTION

This study aims to compare the application of the South African VAT collection methods to e-commerce and transactions in virtual worlds to the application of the GST collection methods employed in Australia to electronic commerce and transactions in virtual worlds.

This chapter provides a basic understanding of what virtual worlds and e-commerce is. The chapter identifies and analyses the South African VAT collection methods and their requirements for applying the requirements to e-commerce and virtual worlds.

#### 2.2 CONSTRUCT OF VIRTUAL WORLDS

According to Camp, (2007:3), virtual worlds, also known as Massively Multiplayer Online Games (MMOG) (Pienaar, 2008:3), are graphic representations of reality, which are made available over the internet. A person who wishes to access a virtual world would typically sign into the virtual world from the virtual world's website and commence participation in the virtual world, similar to when a person logs onto an internet-banking site and commences making payments. However, in the case of virtual worlds, participation goes beyond the boundaries of the relatively simplistic two-dimensional internet-banking web sites.

A person who participates in a virtual world is represented by an online persona called an avatar (Camp, 2007:3). Avatars are three-dimensional characters that will perform a function on a demand given by the player controlling it. For instance, an avatar can be instructed by the click of a mouse to buy a virtual T-shirt from another avatar. If Pinocchio were an online persona, he would be an avatar, Geppetto would be the player, the strings attached to Pinocchio's arms and legs would represent Geppetto's computer. The stage would represent the virtual world.

Stamper (2007) mentions that Second Life is an example of a virtual world. In Second Life, players can use their avatars to create the virtual equivalent of almost any real-life item. A fascinating feature of Second Life is that participants retain intellectual property rights on the virtual things they create (Lederman, 2007:1630). This right, Lederman (2007:1630) argues, encourages participants to be creative and to start businesses resulting in virtual worlds like second life becoming “economic conduit[s]” (Schlimgen, 2010:880) with avatars transacting with other avatars.

Transactions usually occur with one avatar selling a virtual item to another avatar in exchange for either virtual world currency, like Linden Dollars in the case of Second Life, or some other virtual item, like a virtual piece of land. Often players can, and do, exchange their virtual world currency for real world currency as in the case of Second Life where players exchange their Linden dollars (L\$) for United States dollars (US\$). As at 16 September 2012, L\$247 buys US\$1 (Second Life, Not dated).

Evidently, transactions in virtual worlds such as Second Life, involves transactions for real world currency or for a currency with real world value. Where real world currency is exchanged, revenue authorities are bound to seek ways and means in which to levy taxes on these transactions (Pienaar, 2008:28).

### **2.3 CONSTRUCT OF E-COMMERCE**

Akomolede (2008:2) describes e-commerce as “... the buying and selling of goods and services through the internet.” According to Van der Merwe (2003:371), e-commerce is a term used to describe transactions that happen electronically and usually has a connotation to business conducted over the internet.

Downloading computer software is an example of e-commerce (Parrilli, 2008). A supplier makes a certain piece of software available over the internet, the recipient pays for the software and it is downloaded to a computer. No tangible object ever changes hands.

Transactions in virtual worlds and e-commerce may pose some obstacles to the South African VAT collection methods. The South African VAT Act was drafted prior to the dawn

of e-commerce and virtual worlds and no specific provision is made to ensure that these transactions do not escape the tax base.

The current collection methods employed in the VAT Act should therefore be analysed to determine to what extent, if any, the VAT collections methods employed is wide enough to encompass transactions of this modern age.

## **2.4 VALUE ADDED TAX IN SOUTH AFRICA**

The VAT Act contains two VAT collection methods (De Swardt and Oberholzer, 2008:23). They are the vendor registration method and the self-assessment method (De Swardt and Oberholzer, 2008:23).

The vendor registration method is based on the provisions of section 23 of the VAT Act. Section 23 provides for two types of registrations. They are known as compulsory registrations and voluntary registrations (SARS, 2012:12). Once a person is a vendor, that person is required by section 7(1)(a) of the VAT Act to levy VAT on certain supplies of certain goods or services. Section 28 of the Act in turn requires the vendor to calculate the VAT payable, to furnish a return and to pay to SARS the amount calculated by the vendor as payable.

The self-assessment method is based on the provisions of section 7(1)(c), the definition of imported services in section 1 and section 14 of the VAT Act. These sections require any resident of South Africa who receives a service from a non-resident to account and pay over to SARS, the VAT on the service supplied. The service however will only be subject to VAT under the self-assessment method if the service is used or consumed in South Africa for a purpose other than the carrying on of an enterprise. The self-assessment method is therefore aimed at the final consumption in South Africa of services.

### **2.4.1 The vendor registration method analysed**

The vendor registration method revolves mainly around whether a person is carrying on an enterprise as defined or intends to carry on an enterprise as defined. An enterprise is defined in section 1 of the VAT Act as any enterprise or activity conducted continuously or regularly in or partly in the republic in the course of furtherance of which goods or services are supplied to any other person for a consideration.

The above definition of an enterprise identifies several requirements that must be satisfied before a person can or must register for VAT. The requirements are:

- An activity or enterprise must be conducted;
- The activity or enterprise must be conducted continuously or regularly;
- The supply/activity must happen inside South Africa;
- Goods or services must be supplied; and
- The goods or services must be supplied for a consideration.

Section 23 of the Act adds a further requirement that must be satisfied before a person can or must register for VAT. A person is obligated to register for VAT if the amount received from supplies made in the furtherance of an enterprise exceeds R1 million in a twelve-month period or is reasonably expected to exceed R1 million in a twelve-month period (compulsory registration). A person may in certain instances register voluntarily if the value of supplies exceeds R50,000 in a twelve-month period or is expected to exceed R50,000 in a twelve-month period.

The vendor registration method is analysed below for applying the requirements of the vendor registration method to e-commerce and transactions in virtual worlds. As indicated above, the vendor registration method revolves mainly around the definition of enterprise in section 1 of the Act, which definition contains, in part, the requirements of the vendor registration method. Each of the requirements identified above will be analysed below to determine, in the case of both e-commerce and transactions in virtual worlds, whether:

- The underlying subject of e-commerce and transactions in virtual worlds can be said to be a supply of goods or services;
- If a supply of goods or services can be said to exist;

- Whether what is received by the person supplying the goods or service constitutes consideration as defined; and
- Whether the ‘activity or enterprise requirement’ and the ‘in or partly in South Africa requirement’ can be satisfied.

#### **2.4.1.1 Supply of goods or services**

As is evident from the definition of an enterprise mentioned above, goods or services must exist before any supply can meet the enterprise definition requirements. Not only is it important to determine whether goods or services exists for the purpose of the vendor registration method, but also the classification of something as either goods or a services may impact on the manner in which VAT is required to be levied, if any (De Swardt and Oberholzer 2006:18). The definition of goods in section 1 of the VAT Act states that:

*‘ “Goods” means corporeal movable things, fixed property, any real right in 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*

*(c) property; and 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;’*

De Swart and Oberholzer (2006:18) argue that, in terms of the definition of goods in section one of the VAT Act, goods must be physical objects or real rights in a physical object to qualify as goods. De Koker and Kruger (2012) agree that the word “corporeal” in the definition of goods indicates that only tangible objects will qualify as goods for South African VAT purposes.

In the case of e-commerce, no tangible object is exchanged. It follows therefore that it is unlikely that the subject of e-commerce can be classified as goods for South African VAT purposes. Transactions in virtual worlds similarly do not involve any tangible or physical object and accordingly, the subject of transactions in virtual worlds are also unlikely to be

classified as goods. The question then is whether the subject of e-commerce and transactions in virtual worlds can be classified as services. Services are defined in section 1 of the VAT Act as:

*‘ “**Services**” means 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 is defined in such a way to be a catch all concept, including all things that are not goods as defined (De Swardt and Oberholzer, 2006:18). Is the definition wide enough however, to embrace the subject of e-commerce and transactions in virtual worlds?

A survey conducted among VAT specialists in South Africa by De Swart and Oberholzer (2009:19) revealed that the majority of VAT specialists think that the subject of e-commerce should be regarded as services.

Johnston (2011:15) argues that the subject of transactions in virtual worlds qualify as services solely because it cannot be classified as goods. This conclusion reached by Johnston (2011:15) supports the argument of De Koker and Kruger (2012) that it is almost impossible not to classify something either as goods or as services.

A further requirement of the vendor registration method is that there must be a supply of the goods or services. The definition of supply in section 1 of the VAT Act states that:

*‘ “**supply**” includes performance in terms of 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, and any derivative of supply shall be construed accordingly.’*

The sale of computer software over the internet would satisfy the above definition of a supply and consequently the supply requirement of the vendor registration method. The

question however from a South African point of view is whether a transaction in a virtual world also qualifies as a supply as defined?

According to Stiglingh (2011:944), the definition of supply is so wide that it can be said to include barter transactions. A barter transaction is a transaction whereby goods or services are supplied in exchange for something other than cash. Pienaar (2008:36) mentions that transactions in virtual worlds represent barter transactions with avatars exchanging virtual world currency for virtual goods or virtual goods for other virtual goods.

Since transactions in virtual worlds are barter transactions and the definition of supply includes barter transactions, the transactions in virtual worlds satisfy the definition of supply and consequently this requirement of the vendor registration method.

#### **2.4.1.2 Consideration**

The definition of enterprise in the VAT act requires the supply of goods or services to be for consideration before a person may be required to register for South African VAT. If supplies of goods or services are made for no consideration, the vendor registration method does not apply.

The definition of consideration in section 1 of the VAT Act states that:

*“consideration”, in relation to the supply of goods or services to any person, includes any payment made or to be made (including any deposit on any returnable container and tax), whether in money or otherwise, or any act or forbearance, whether or not voluntary, in respect of, in response to, or for the inducement of, the supply of any goods or services, whether by that person or by any other person, but does not include any payment made by any person as a donation to any association not for gain: Provided that a deposit (other than a deposit on a returnable container), whether refundable or not, given in respect of a supply of goods or services shall not be considered as payment made for the supply unless and until the supplier applies the deposit as consideration for the supply or such deposit is forfeited;’*

The definition includes any payment made or to be made for a supply whether in money or otherwise. E-commerce does not pose any obstacle for this requirement of the VAT Act since the supply of an electronic item is in most instances supplied for money as payment in relation to a supply.

The South African position is however not entirely as simple in the case of transactions in virtual worlds. What is meant by the words in the definition of consideration “in money or otherwise”?

The notion of a receipt in something other than cash was dealt with by the South African courts in relation to the Income Tax Act. In *CIR v Butcher Bros (Pty) Ltd* (1945 AD 301) (13 SATC) 21 the court held that when income is received in something other than cash, the something other than cash must have an ascertainable money value before the recipient can be subject to South African Income Tax on the receipt of something other than cash.

In terms of section 10(3) of the VAT Act, where a supply is made in return for payment in the form of something other than cash, the value of the receipt, and therefore the consideration, must be the open market value of the receipt. The VAT Act therefore espouses to the Income Tax Act in this regard. If what is received in return for a supply does not have an open market value, i.e. an ascertainable money value, no consideration would have been received.

According to Pienaar (2008:29), income earned from unstructured virtual worlds has an ascertainable money value because virtual world currency can be exchanged for real world currency and accordingly has an ascertainable money value.

It follows therefore that when a supply of a service occurs in a virtual world and the supplier receives virtual world currency, consideration in the form other than money has been received as payment for the supply. Since the virtual world currency does have ascertainable money value this requirement of the enterprise definition can also be satisfied in the case of transactions in virtual worlds.



### **2.4.1.3 Activities conducted continuously and regularly in or partly in South Africa.**

The definition of an enterprise requires that activities are conducted continuously and regularly. The word activity is not defined in the VAT Act and therefore takes its usual meaning which is defined to include any action (Dictionary.com, Not dated). The word 'enterprise' as used in the definition of enterprise must also take its usual meaning which is defined to include any business (Oxford reference online premium, not dated).

Since both the words enterprise and activity are used in the definition of enterprise it may be argued that the word activity embraces any activity that is not necessarily considered a business in the usual sense (it should be noted that activities that constitute a hobby is specifically excluded from the definition of enterprise). It follows that the vendor registration method is not dependent on whether a person is conducting a business *per se*.

Accordingly, activities conducted of, for instance maintaining a web site or the activity of instructing an avatar in a virtual world or signing into a virtual world satisfies the "activity or enterprise" requirements as these activities constitute actions, even though these actions do not necessarily represent the carrying on of a business.

The reference to 'continuous' and 'regular' in the definition of enterprise does not refer to the supply that must be continuous or regular but rather to the activity that must be continuous or regular (Hay, 2011:23). Accordingly, a person should continuously or regularly conduct an action or business before the enterprise definition requirement is satisfied.

What is meant by the words continuous and regular was considered by the New Zealand court in *Allen Yacht Charters limited v CIR* (1994) 16 NZTC 11 where it was held that the word 'continuous' means the activity must be carried on all the time and that the word 'regular' means the activity must be carried on at reasonably short intervals. The "continuous and regular" requirement therefore seems to be satisfied if a person at least at relatively short intervals maintains a website or instructs an avatar or signs into a virtual world.

Evident from the above is that e-commerce and transactions in virtual worlds pose little to no obstacle to the activity or enterprise and continuous or regular requirements of the vendor registration method.

The 'in, or partly in, South Africa' requirement of the vendor registration method however deserves further investigation. In this regard, De Swardt Oberholzer (2006:21) found that 75% of the VAT specialists in a survey thought that a foreign supplier would be carrying on an enterprise in South Africa if that foreign supplier hosted a website from a server located inside South Africa. The survey however did not appear to address the situation where a South African supplier of e-commerce operates a website from inside South Africa.

Johnston (2011:20), in applying the principle set out by De Swardt and Oberholzer to supplies in virtual worlds, makes use of an example of a virtual music store. In his example a virtual music store is created where participants of the virtual world can buy and listen to music.

Johnston (2011:19) continues to mention in the context of the 'in, or partly in, South Africa' requirement that the question of where the virtual music store is situated and therefore where the place of supply is, determines whether the requirement has been satisfied. Johnston then concludes (2011:20) that if the server hosting the virtual world is not in South Africa, the operator of the virtual music store will have "no obligation to register for VAT in South Africa." No distinction is made between a local and foreign supplier. The argument advanced by Johnston therefore takes the stand point that the 'in, or partly in, South Africa' requirement is concerned with the place of the supply. This argument is henceforth referred to as "the place of supply argument".

Hay (2011:25), in analyzing the 'in, or partly in, South Africa' requirement in the context of virtual worlds, states that it is the place where the activities are conducted that forms the enquiry of the 'in, or partly in, South Africa' requirement of the enterprise definition. According to Hay (2011:25), the place where the supply takes place is irrelevant and requirement rather looks to the place where the activity takes place. This argument will henceforth be referred to as the place of activities argument.

According to De Koker and Kruger (2012) South Africa's VAT system is a destination based system which means that all supplies consumed in the Republic should be subjected to VAT (De Koker and Kruger, 2012). Hay (2011:25), Johnston (2011:18), and De Swardt and Oberholzer (2006:20) to mention a few, all agree that the VAT Act aims to tax all supplies consumed in South Africa.

The statement above begs the question of what 'consumption' entails. In the case where services are supplied, as is the case with e-commerce and supplies in virtual worlds, it is the use of the service that represents consumption. It follows that if the service is used in South Africa; VAT should be levied on the supply of that service (provided the other requirements are satisfied). Accordingly, the VAT collection methods employed in South Africa should ensure that where services are supplied and used in South Africa that VAT is collected.

Both the place of supply argument and the place of activities argument are further analyzed below by reference to hypothetical scenarios in the context of virtual worlds and e-commerce in order to determine which argument espouses best to the destination principle.

### **The place of supply argument**

This argument's application to electronic commerce and transactions in virtual worlds are best explained by way of a hypothetical situation. De Swardt and Oberholzer (2006:14) conducted a survey amongst VAT specialists in South Africa that was based on a case study. In the case study a foreign supplier supplied an electronic item to a South African resident through a website. This case study will be used and elaborated on below to indicate the impact of the place of supply argument:

Taxpayer 1, a tax resident of South Africa, sets up a website from which a person can download computer software. The website is hosted from a server located outside South Africa and thousands of people from around the world buy and download the software from Taxpayer 1's website. Taxpayer 1 is required to maintain his website and does so

from his computer wherever he may find himself at a particular point in time and when maintenance is called for, but mostly, he does this from his home in Johannesburg.

According to the place of supply argument, the place of supply is not in South Africa but rather at the place where the server is located. Accordingly, Taxpayer 1 does not meet the 'in, or partly in, South Africa' requirement and will not be required to register for VAT in South Africa. It would make no difference to the conclusion if Taxpayer 1 conducted his activities outside South Africa.

In the case of transactions in virtual worlds, a similar conclusion is reached. It has been indicated above that Johnston (2011:19), in applying the principle set out by De Swardt and Oberholzer, uses an example of a virtual music store to drive the place of supply argument home. This hypothetical scenario will be used and elaborated on below to fully indicate the impact of the place of supply argument in the case of transactions in virtual worlds:

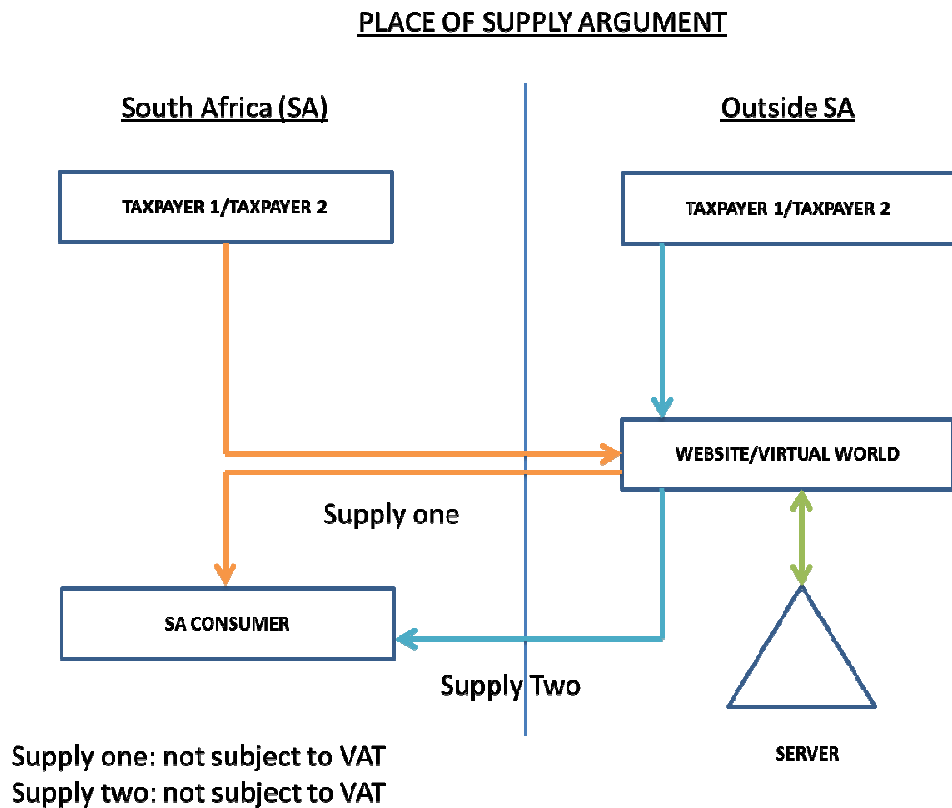
Taxpayer 2, a South African tax resident, has a presence in the virtual world called Second Life. Taxpayer 2 signs into Second Life from her computer in her home in Johannesburg. Inside Second Life, Taxpayer 2 buys and sells music to other avatars controlled by players from all around the world. Second Life's website is hosted from a server located outside South Africa.

Based on the place of supply argument, the place where Taxpayer 2 supplies her virtual music is not in South Africa and accordingly she does not have to register for VAT. It would make no difference to the conclusion if Taxpayer 2 conducted her activities outside South Africa.

In order to determine whether this argument espouses to the destination principle it has to be considered where consumption of the computer software or virtual music occurs, which requires further facts to be added to the two hypothetical scenarios sketched above. If a South African resident downloads the software from Taxpayer 1's website, consumption happens in South Africa. However, Since Taxpayer 1 does not satisfy the 'in, or partly in,

South Africa' requirement, Taxpayer 1 is not required to register for VAT and the supply would fall through the South African VAT net.

Similarly, if a South African resident who participates in the virtual world buys virtual music from Taxpayer 2, the service is consumed inside South Africa and no VAT would be collected on the supply. To hold that the service is consumed on a server would mean that avatars are capable of consuming services. It is concluded that such an argument is not tenable. Figure 1 below depicts the conclusions based on the place of supply argument:



**Figure: 1 Place of supply argument**

The place of supply argument therefore highlights a major deficiency in the South African VAT collection method if it is held to be the correct approach to the in or partly in South Africa requirement of the vendor registration method.

## **The place of activities argument**

If the place of activities argument is applied to the facts of the case studies above a different conclusion is reached. Since Taxpayer 1 conducts his maintenance activities mostly in South Africa, Taxpayer 1 will satisfy the 'in, or partly in, South Africa requirement' and may be required to register for VAT in South Africa.

If however Taxpayer 1 conducted his maintenance activities mostly outside South Africa, he would not meet the requirement because no activity is partly carried on in South Africa.

In the case study of Taxpayer 2 it could be argued that Taxpayer 2 is conducting an activity in two places. An activity is conducted by her actions on her computer in Johannesburg, South Africa, and at the place where the server is located. Taxpayer 2 nevertheless is conducting an activity/action partly in South Africa and therefore satisfies the 'in, or partly in, South Africa' requirement.

However, if Taxpayer 2 instructed her avatar from a place outside South Africa, she would not satisfy the 'in, or partly in, South Africa' requirement since none of her activities are conducted from a place in South Africa.

The place of activities argument appears to align better with the destination principle to the extent that the supplier conducts his/her/its activities in South Africa. The activities argument further also aligns better with the definition of supply in section 1 of the VAT Act which states that a supply does not have to be in South Africa in order to attract VAT.

Where the supplier conducts his/her/its activities outside South Africa, the supply would fall short of the vendor registration method and may potentially be a problem for the VAT collection methods in South Africa. The conclusions reached under the place of activities argument is depicted in Figure 2 below:

PLACE OF ACTIVITIES ARGUMENT

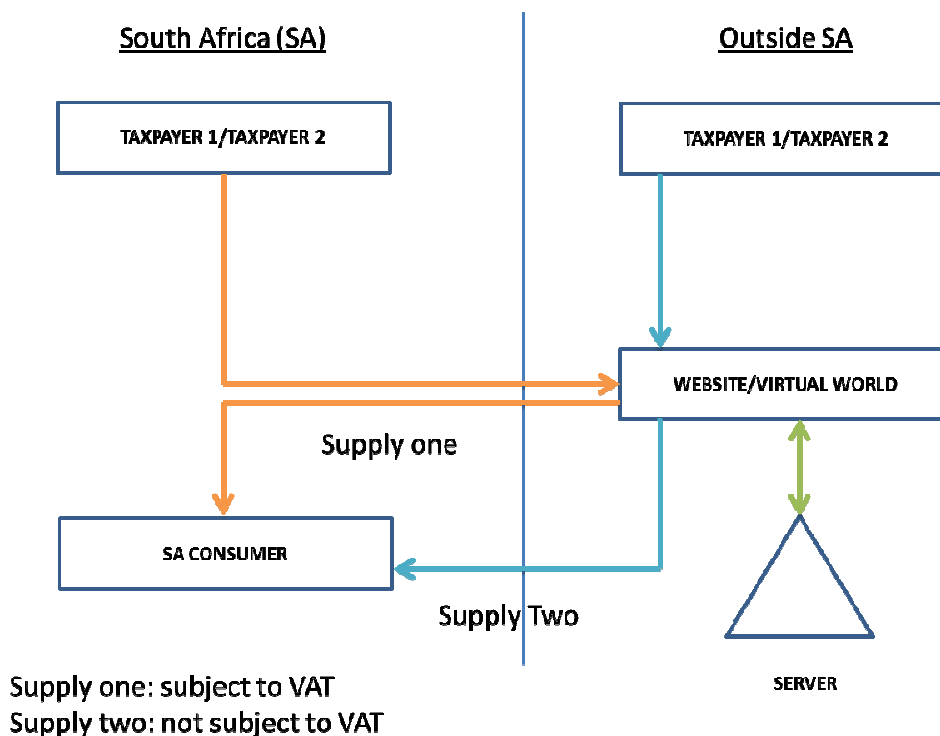


Figure 2: Place of activities argument

**2.4.1.4 The R1 million threshold**

Before a person is required to register under the vendor registration method, that person must have made supplies to the value of R1m in the course of carrying on an enterprise. In the case of e-commerce transactions, where real money is traded for services, this requirement should not be problematic.

However, where supplies are made in virtual worlds, it begs the question of when it should be determined whether the threshold has been reached. Is it when virtual world supplies of services has yielded enough virtual world currency to equal one million rand or when the player cashes out the virtual world currency for real world currency?

According to Schlimgen (2010:892), there are two potential ways to view transactions in virtual worlds such as Second Life. There is the internal viewpoint and the external viewpoint (Schlimgen, 2010:892).

In terms of the external viewpoint, income should be taxed when players cash out virtual world currency for real world currency (Camp, 2007:59-60). Schlimgen (2010:896) concludes that the external viewpoint will be most acceptable in the case of consumption taxes such as VAT. The reason for this, Schlimgen (2010:896) argues, is that it is much easier from an enforcement point of view to collect the taxes when players cash out their virtual world currency.

In terms of the internal viewpoint, income should be taxed when it is earned in world (Lederman, 2007:1653). From a South African income tax approach, Pienaar (2008:36) states that income earned in virtual worlds will qualify as gross income inside the virtual world, before a player cashes out his virtual world earnings.

The vendor registration method requires that the value of the supplies exceed R1m. The value of a supply is regulated by section 10 of the VAT Act. Section 10(3) of the VAT Act states that the value of a supply shall be the consideration received for the supply. Where the supply is a supply in exchange for something other money, the value of the supply shall be the open market value of the supply (section 10(3)(b) of the VAT Act).

As mentioned above the supply of services in virtual worlds has an ascertainable money value. It can therefore be concluded that once supplies have been made in a virtual world and the consideration received for the supply in the virtual world has an open market value of R1m, the threshold has been reached. It seems that from a South African VAT point of view, the R1m threshold must be determined in the virtual world and therefore follows the internal viewpoint discussed above. Schlimgen (2010:896) argues that the internal viewpoint is less effective from a collection point of view.

#### **2.4.2 The self-assessment method analysed**

The self –assessment method revolves mainly around the definition of imported services in section 1 of the VAT Act, which states that:

*“imported services’ means a supply of services that is made by a supplier who is resident or carries on business outside the Republic to a recipient who is a resident of the Republic*



*to the extent that such services are utilized or consumed in the Republic otherwise than for the purpose of making taxable supplies;'*

Section 7(1)(c) of the VAT Act requires VAT to be collected on the supply of any imported service. Accordingly, a South African resident who imports services from a non-South African resident is required to collect VAT on that service, if the South African resident is not going to use the service to make a taxable supply. A taxable supply is defined as a supply which is subject to VAT in terms of section 7(1)(a) of the Act. Supplies which are subject to VAT under section 7(1)(a) of the Act are supplies made in the course of furtherance of an enterprise. The definition of enterprise was analysed above.

It can therefore be concluded that the self-assessment method is aimed at all supplies of services to consumers who are not carrying on an enterprise as defined as defined, *i.e.* to end consumers inside South Africa.

Critical to the application of the self-assessment method is the residence of the person supplying the service and the person receiving the service. For the purpose of the VAT Act, a person is a resident of South Africa if that person is ordinarily resident in South Africa or if that person is physically present in South Africa for a specific number of days in a five-year period.

The application of the self-assessment method to e-commerce and supplies in virtual worlds is best explained with reference to the earlier case studies. If Taxpayer 1, in the earlier hypothetical scenario, was not a South African resident and carried on no activities in South Africa, the supply of software to a South African resident will be subject to VAT in terms of the self-assessment method provided that the South African recipient is not using the service to make taxable supplies. Similarly, if Taxpayer 2 was not a resident of South Africa the supply of the virtual music to a South African resident would be subject to VAT.

It appears if the self-assessment method therefore ensures that the shortcomings of the vendor registration method, highlighted by the place of supply argument, is addressed to some extent (supply two in Figure 1 above would accordingly be subject to VAT under the self-assessment method). However, if Taxpayer 1 and Taxpayer 2 are residents of South

Africa and conducts no activities in South Africa, neither the self-assessment method nor the vendor registration method will ensure VAT is collected on services consumed in South Africa.

The only deficiency with the vendor registration method, highlighted by the place of activities argument was in the situation where Taxpayer 1 and Taxpayer 2 conducted their activities outside South Africa and consumption took place in South Africa. If both Taxpayer 1 and Taxpayer 2 are non-residents, the only deficiency in the vendor registration method is covered by the self-assessment method (Supply two in Figure 2 above would be subject to VAT in terms of the self-assessment method).

However if Taxpayer 1 and Taxpayer 2 are residents of South Africa and are conducting all their activities outside South Africa and consumption takes place in South Africa, both the vendor registration method and the self-assessment method would fail in collecting the VAT on the supplies consumed in South Africa. It is however difficult, if not impossible, to imagine a situation where a person conducts an activity continuously and regularly outside South Africa without that person becoming a non-resident.

The self-assessment collection method appears to provide for the shortcomings of the vendor registration method, but only to the extent that the supplier is not a South African resident. However, as De Swardt and Oberholzer (2006:21) point out it is almost impossible to determine whether a supplier of electronic goods or services is a resident or not. This holds true in the case of transactions in virtual worlds as well. Thus, even though the self-assessment method may serve as a backup in normal circumstances, its application in the case of electronically supplied goods or services may only be effective in theory.

In terms of section 14(3) of the VAT Act, the value to be placed on an imported service shall be the consideration for the supply. As indicated above, consideration is the amount of money paid for a supply. Therefore, in the case of a non-resident person supplying a virtual world to a resident, the resident will be required to pay VAT on the value of money paid to the non-resident for partaking in the virtual world.

In the case of supplies inside virtual worlds, the resident does not pay the non-resident in money. It therefore stands to be determined whether the resident must account for the output tax when real money is used to pay for the service or when virtual world currency is used to pay for the service.

As indicated above, South Africa's VAT system seems to follow the internal viewpoint and therefore, the resident will have to account for the VAT when the service is paid for in virtual world currency. As Schlimgen (2010:896) argues, this approach is less effective from a collection point of view.

## **2.5 SOUTH AFRICAN VAT COLLECTION METHODS SUMMARISED**

The vendor registration method requires that activities be carried on continuously and regularly in terms of which goods or services are supplied for a consideration, the value of which must be equal to at least R1 million. As indicated above electronic commerce and transactions in virtual worlds pose little to no threat to these requirements of the vendor registration method even though the internal viewpoint may be considered less effective from an enforcement point of view.

E-commerce and transactions in virtual worlds may however pose a threat to the 'in, or partly in, South Africa requirement depending on which argument is correct as to the application of this requirement. If the place of supply argument is correct, the vendor registration method is not wide enough to embrace e-commerce and transactions in virtual worlds.

If the place of activities argument is correct, the vendor registration may ensure that VAT is collected on e-commerce and transactions in virtual worlds but only to the extent that activities are carried on in South Africa. Where activities are carried on outside South Africa and consumption of a service in terms of that activity occurs inside South Africa, the vendor registration method is not wide enough to embrace these supplies.

It appears however that where the vendor registration method fails, the self-assessment method ensures that VAT is collected on services consumed in the Republic with its only drawback being the question of how to establish the residency of the persons involved.

## **2.6 CONCLUSION**

The analyses above identified the South African VAT collection methods and applied the requirements of the collection methods to e-commerce and transactions in virtual worlds. The chapter identified that while most of the South African VAT collection methods' requirements effectively apply to e-commerce and transactions in virtual worlds, the 'in, or partly in, South Africa' requirement may not. While one interpretation of this requirement renders the requirement satisfied, the other does not.

The distinction between the two requirements is that the place of supply argument places its main reliance on the place of supply and thereby requires servers to be in South Africa to satisfy the in or partly in South Africa requirement. The activities argument places its main reliance on the place where the activities are carried on and does not require the presence in South Africa of a server. If the place of supply argument is held to be correct, the main issue faced by the registration method in the context of e-commerce and transactions in virtual worlds is that consumption of virtual or digital services could take place in South Africa, without VAT being capable of collection on that consumption.

The Australian equivalent of the VAT Act, called the GST Act, is similar to the VAT Act and employs similar collection methods. These collection methods are identified in Chapter 3. Once the collection methods have been identified, the extent of its application in the current context will be compared against the extent of the South African requirements' application to determine if similar issues arise in Australia as in South Africa.

## CHAPTER 3

### COMPARATIVE ANALYSIS

#### 3.1 INTRODUCTION

Chapter 2 identified the VAT collection methods employed in South Africa and analysed the application of its requirements in the context of virtual worlds and e-commerce. The Australian consumption tax Act, called the GST Act, is similar to the South African VAT Act and employs collection methods that are to some extent similar to the South African VAT collection methods. In this chapter, the application of the South African VAT collection methods in the context of virtual worlds and e-commerce is critically compared against the extent of GST collection methods employed in Australia in the context of e-commerce and transactions in virtual worlds.

#### 3.2 GOODS AND SERVICES TAX IN AUSTRALIA

In this section, the collection methods employed in the GST Act are clarified and its application to e-commerce and virtual worlds are critically analysed from a South African perspective.

Millar and McCarthy (2012:29) states that the Australian GST Act levies GST on all “taxable supplies” and “taxable importations”. In terms of section 9-5 of the GST Act, a person makes a taxable supply if:

- A supply is made for a consideration;
- The supply is made in the course of furtherance of an enterprise;
- The supply is connected with Australia; and
- The person is registered or required to be registered.

Evident from the above is that a person must be registered or must be required to be registered in order for a supply to be subject to GST. This requirement is similar to that of the South African VAT Act, which requires a person to be a vendor before that person

must charge VAT on a supply. A vendor in turn is defined as any person who is or is required to be registered for VAT.

Millar and McCarthy (2012:32) indicated that a person would be required to be registered for Australian GST if that person carries on an enterprise and the GST turnover of that enterprise is equal to at least AUD 75,000. Millar and McCarthy (2012:32) also states that the two key factors of the registration requirement are the concepts of “enterprise” and “GST turnover”.

Evident from the above is that the GST Act, like the South African VAT Act, employs a registration method for the collection of GST. It is however important to clarify the concept of “GST turnover” and “enterprise” for determining the requirements of the Australian registration method.

Section 9-20 of the GST Act states that an “enterprise” is an activity or series of activities done in the form of a business or in the form of an adventure or concern in the nature of trade or on a regular and continuous basis in the form a lease, license or other grant of an interest in property . This requirement of the GST Act will be compared to the VAT Act in more detail below.

“GST turnover” in turn is defined in section 188-15 of the GST Act to mean the sum of the values of all supplies made by a person or which is likely to be made in a twelve-month period. Certain exclusions to this wide definition of GST turnover will be discussed in detail below for the purposes of determining the requirements of the GST registration method and for comparing the extent of its application in the context of e-commerce and transactions in virtual worlds to the extent of the South African registration method in this context.

It was indicated above that the GST Act levies VAT on all “taxable supplies” and “taxable importations”. What constitutes a taxable supply was briefly set out above. It however still stands to be determined what a taxable importation is in terms of the GST Act.

According to section 13-5 of the GST Act, taxable importations are importations of goods that are imported for home consumption. The GST Act therefore also, like the South African VAT Act, levies and therefore collects GST on certain importations.

However, the Australian GST Act appears to only levy GST on importations of goods as opposed to the South African VAT Act that levies VAT on the importation of both goods and services. There are however special rules for telecommunication services contained in division 84 of the GST Act that effectively require the importer of a service to bear the GST cost (Alexiou and Morrison, 2004:23) as in the case of the South African VAT Act. This method of collecting GST on the importation of certain services is referred to as the reverse charge mechanism (Alexiou and Morrison, 2004:23).

Accordingly, the reverse charge mechanism employed in the Australian GST Act is similar, at least in principle, to the South African self-assessment method. The requirements of the Australian reverse charge mechanism will be elaborated on below and the extent of its application in the context of virtual worlds and e-commerce compared to the extent of the South African self-assessment method's application in this context.

From the above it appears as if the Australian GST Act, like its South African counterpart, provides for two methods of GST collection, a registration method and a reverse charge mechanism. The requirements of these two collection methods are elaborated on below and its application in context of e-commerce and transactions in virtual worlds determined and compared against the relevant South African requirement.

### **3.2.1 The registration method**

The origin of the Australian registration method is the definition of GST turnover. If a person does not have GST turnover, that person will not be required to register for GST (Millar and McCarthy, 2012:32). Excluded from the definition of GST turnover are supplies made that are not for a consideration and supplies that are not connected to Australia.

From the exclusions, several requirements of the Australian GST registration method are evident. The first requirement is that there must be a supply. The second is that the supply

must be for a consideration and thirdly, the supply must be connected to Australia. A further requirement is that it must be determined whether the things being supplied are goods or services as this classification has an impact on whether the supply is connected to Australia or not (Alexiou and Morrison, 2004:17). The second last requirement is that the GST turnover should be at least AUD 75,000. The final requirement is that an enterprise must be carried on.

The requirements identified above will be analysed below in the context of e-commerce and transactions in virtual worlds and compared to the relevant South African requirement.

### **3.2.1.1 *Supply of goods or services for a consideration***

The definition of supply in section 9-5 of the GST Act states that a supply means any supply whatsoever and includes among other things:

- a supply of goods or services;
- a provision of advice or information;
- a creation, grant, transfer, assignment or surrender of any right;
- an entry into or release from any obligation;
- any combination of the above.

According to Martin (2000:263) it should be assumed that where something has been provided absolutely from one person to another that a supply has been made for the purposes of the Australian GST Act by virtue of the fact that the definition of supply is all embracing. Martin (2000:263) however adds that the something being supplied must be something that the Australian law recognises as being capable of being provided from one person to another.

It is doubtful whether, in relation to e-commerce, a supply as envisaged in the GST Act would not be made. In the case of transactions in virtual worlds however, a legal question may arise as to whether the Australian law recognises the supply of, for example, of a virtual T-Shirt, as something capable of being supplied.



Walpole and Gray (2010:57) mention however, that supplies in virtual worlds should satisfy the supply requirement of the GST Act and continues to mention, unlike Martin (2000:263), that the legal characterisation of the item is not conclusive. It may therefore be concluded that both e-commerce and supplies in virtual worlds satisfy the supply requirement of the GST Act.

Alexiou & Morrison (2004:17) state that the Australian GST Act is not drafted with reference to goods or services. It however remains an important criterion for the purpose of the GST Act to determine the nature of an item being supplied since the nature of an item may determine whether the supply is connected to Australia or not (Alexiou and Morrison, 2004:17).

Millar and McCarthy (2012:45) also stress the importance of determining the nature of the thing being supplied. For this purpose, Millar and McCarthy (2012:45) identifies three categories of things that can be supplied under the GST Act. These categories are supplies of goods, supplies of real property and supplies of anything other than goods.

Goods as defined in section 1 of the GST Act “means any form of tangible personal property”. Real property in turn is defined to include “any interest in or right over land or a personal right to call for or be granted any interest in or right over land or license to occupy land or any other contractual right exercisable over or in relation land.”

Millar and McCarthy (2012:46) points out that there is no separate definition in the GST Act of what a supply of a service is. However, any supply other than a supply of goods or real property would constitute a supply of services (Millar and McCarthy, 2012:46).

In the case of e-commerce, the supply is neither a supply of any tangible object, nor a right in land. It follows therefore that supplies of electronic items should be classified as supplies of something other than goods. Millar and McCarthy (2012:46) points out that when a supply is something other than a supply of goods, the supply can be said to be a supply of a service.

It follows therefore that e-commerce will represent a supply of services for the purposes of the GST Act, a conclusion also reached by Alexiou and Morrison (2004:19) who state that the supply of electronic items shall be seen as a supply of a service for the purpose of the GST Act.

Supplies made in virtual worlds are also not supplies of tangible goods and should therefore be classified as services. Walpole and Gray (2010:57) agree that the supply of virtual items in virtual worlds will constitute a supply of a service under the Australian GST rules.

As indicated above, the supply, be it of a good or of a service, must be a supply in return for a consideration. If no consideration is received for the supply, the person making the supply will have no GST turnover and will accordingly not be required to register for GST.

Walpole (2008:9) states that consideration includes:

- “(1) (a) *any payment, or any act or forbearance, in connection with a supply of anything;*  
*and*  
(b) *any payment, or any act or forbearance, in response to or for the inducement of a supply of anything.*”
- (2) *It does not matter whether the payment, act or forbearance was voluntary, or whether it was by the \*recipient of the supply’ ”.*

The word “payment” as used in the definition of consideration is not defined in the GST Act and it is therefore not certain whether supplies made in return for something other than money would constitute consideration for the purposes of the GST Act.

According to the Australian taxation office (ATO) (2012:25), where consideration takes the form of a non-monetary payment, the value of the consideration shall be the GST inclusive market value of the non-monetary receipt.

In the context of e-commerce, the consideration requirement of the GST Act will easily be satisfied where a person makes a payment for, for example, the supply of computer software.

In relation to transactions in virtual worlds, Walpole and Gray (2010:57) argue that since virtual world currency has real money value, the supply of a virtual item for virtual world currency would constitute a supply for consideration.

Consequently, supplies made in virtual worlds and e-commerce does not pose any obstacles for the following requirements of the GST Act:

- There must be a supply
- The supply must be of either a good or of a service
- The supply must be for a consideration

From the above it is evident that both the GST Act and the VAT Act requires there to be a supply. The definition of supply in section 1 of the VAT Act and the definition of supply in section 9-5 of the GST Act are wide enough to embrace e-commerce and virtual world transactions.

Also evident from the above is that it is important from both a South African and Australian perspective to determine the nature of the thing being supplied. Both Acts render the supply of e-commerce and virtual items supplies of services. The classification of virtual and electronic items therefore does not appear to be a point of concern for either the South African or Australian VAT and GST collection methods.

The Australian GST Act, like its South African counterpart, requires the supply to be made for a consideration, for some payment in return for the supply. E-commerce and transactions in virtual worlds pose little to no threat to these requirements of the two Acts.

### **3.2.1.2 Connected to Australia**

Millar and McCarthy (2012:52) states that the Australian GST Act adheres to the destination principle, which means that the Australian GST Act seeks to levy GST on

goods or services consumed in Australia. This is achieved in the GST Act through the connection to Australia requirement.

According to Alexiou and Morrison (2004:18), a supply must be connected with Australia before the supply is subject to GST. Also evident from the exclusion to the definition of GST turnover is that where supplies are not connected to Australia, a person will not be required to register for GST since that person will have no GST turnover.

Alexiou and Morrison (2004:18) state that there are two ways in which a supply can be connected to Australia:

- If the thing is done in Australia; or
- If the supplier makes the supply through an enterprise that the supplier carries on in Australia

Walpole (2008:10) however mentions that a supply can be connected to Australia by way of section 85-5(1) of the GST Act, a special dispensation for telecommunications. He states (2008:10) that where telecommunication is supplied and used or enjoyed in Australia, the supply will be connected to Australia “irrespective of the place of the location of the supplier.”

According to Walpole (2008:10), a telecommunication supply is defined as “transmission, emission or reception of ... writing, images, sounds or information of any kind by wire... optical or any other electromagnetic means.” It also includes “provision of access to global information networks”. Walpole (2008:10) concludes that electronic commerce is typically covered by this definition.

Accordingly, whether a local or foreign supplier of e-commerce makes a supply to a/another Australian resident, the supply will be connected to Australia through division 85 of the GST Act and the supplier may therefore be required to register for Australian GST.

Supplies in virtual worlds however do not necessarily fit the definition of telecommunication supplies (Walpole, 2008:10). The question is therefore whether supplies in virtual worlds can be connected to Australia. It is concluded that the only way in which supplies in virtual

worlds can be connected to Australia is if the supplier does something from a place inside Australia or if the supplier makes a supply through an enterprise that the supplier carries on inside Australia.

It is concluded that if a person logs into a virtual world from a computer inside Australia and makes supplies in the virtual world, that person would be doing something from inside Australia and accordingly the supply will be connected to Australia. Walpole and Gray (2010:58) agree that supplies from one Australian to another inside a virtual world would be subject to Australian GST and would therefore satisfy the “connection to Australia” requirement.

According to Walpole and Gray (2010:58), the real problem from an Australian point of view would be supplies from a non-Australian supplier of virtual services to an Australian recipient. The supplies by a non-Australian resident will only be connected to Australia if the non-Australian supplier makes a supply through an enterprise that the supplier carries on in Australia.

The GST Act therefore connects a supply with Australia in the form a permanent establishment requirement (Millar and McCarthy, 2012:37). If a supply is made through a permanent establishment in Australia, it will be connected to Australia and this requirement of the registration method will be satisfied in the case of a non-Australian supplier of virtual items in a virtual world. A permanent establishment is defined in the GST Act as:

- A place where the person is carrying on a business through an agent; and
- A place where a person has, is using or is installing substantial equipment or substantial machinery.

Alexiou and Morrison (2004:20) state that the definition in the GST Act of a permanent establishment can be interpreted against what the Organisation for Economic Cooperation and Development (hereinafter referred to as the OECD) considers a permanent establishment to be.

In terms of the OECD commentary on article 5 of the model tax treaty (OECD, 2010:C(5)-2) a permanent establishment is a fixed place of business through which an enterprise is

wholly or partly carried on. The OECD (2010:C(5)-4) considers the term 'fixed' to mean that the place of business must be established at a distinct place with a certain degree of permanence, which means the geographical location of the business must be fixed.

A place of business is considered to be a premises, facilities or installations used for carrying on a business (OCED, 2010:C(5)-2). The OECD (2010:C(5)-2) also mentions that whether the place is used wholly or exclusively for business purposes is irrelevant. In addition, the OECD (2010:C(5)-2) mentions that a place of business will also exist where the enterprise merely has space at its disposal.

In the case of supplies made in virtual worlds, the question is therefore whether the supplier is carrying on a business through a fixed place of business inside Australia. The answer to this question appears to be negative. Alexiou and Morrison (2004:20) suggest that while a website is not a physical place of business for the purposes of the GST Act, a server would be.

It follows therefore that where the virtual world is hosted from a server outside Australia, the foreign supplier would not be required to register for GST since that person will have no GST turnover by virtue of the fact that no supplies are connected to Australia. Walpole and Gray (2010:58) agree that the GST Act does not provide for supplies of virtual items from a foreign supplier to a local recipient, even though consumption takes place in Australia.

The 'connection to Australia' requirement of the GST Act is similar to the South African 'in, or partly in, South Africa' requirement." What is however important to note from the outset is that the Australian GST Act has a special dispensation insofar as e-commerce is concerned. This dispensation, contained in division 85 of the GST Act, effectively avoids all the issues raised in Chapter Two regarding the 'in, or partly in, South Africa' requirement.

To this extent the GST Act appears to be superior to the VAT Act if only because a special dispensation has been made for e-commerce to connect these supplies to Australia. No such dispensation exists in the VAT Act.

However, as indicated above, the special dispensation in the GST Act does not embrace transactions in virtual worlds. The normal connection to Australia rules should therefore be applied to determine if transactions in virtual worlds could be connected to Australia. This can only be the case if something is done in Australia or if a supplier makes a supply through a permanent establishment in Australia.

It was mentioned above that supplies in virtual worlds from an Australian resident to another person in a virtual world would be connected to Australia because the supplier is doing something from inside Australia. If the place of activities argument is accepted as the correct interpretation of the 'in, or partly in, South Africa' requirement, then supplies from a South African resident inside South Africa to another person may satisfy that requirement provided that the South African resident conducts the underlying activity on a continuous or regular basis. The additional requirement in the South African legalisation that the underlying activity must be conducted on a continuous or regular basis appears to be absent from its Australian counterpart.

However, if the place of supply argument is accepted as the correct interpretation of the 'in, or partly in, South Africa' requirement and the server of the virtual world is not inside South Africa, then the supply will never satisfy this requirement. If this argument is correct, then the GST Act is superior to the VAT Act.

It therefore stands to be determined which argument is correct as to its interpretation of the 'in, or partly in, South Africa' requirement of the South African vendor registration method. For this purpose, it is necessary to return briefly to the definition of enterprise and supply in section 1 of the VAT Act. The definition of enterprise states that:

Any enterprise or activity conducted continuously or regularly in or partly in the Republic in the course of furtherance of which goods or services are supplied to any other person for a consideration is an enterprise.

It is concluded that the definition of an enterprise places its main reliance on the place where the activity is conducted. No mention is made to the place of the supply.

The definition of supply in turn includes a sentence that states that the place of supply is irrelevant. It follows therefore that the place of activities argument aligns better with the definition of enterprise and the definition of supply in section 1 of the VAT Act. It was also indicated in Chapter 2 that the place of activities argument aligns better with the destination principle.

It is however noted that the place of supply argument appears to, like its Australian counterpart, connect a supply to South Africa in the form of a permanent establishment requirement. However, based on the analyses above, the place of activities argument is more accurate than the place of supply argument. It is nevertheless accepted that should the VAT Act aim to connect supplies to South Africa without a permanent establishment requirement, absurd results may follow. It is outside the scope of this study to determine whether the VAT Act in fact contains a permanent establishment requirement when the definition of enterprise and supply suggests otherwise.

Therefore, both the South African and Australian VAT and GST Acts embrace supplies in virtual worlds as long as the person making the supplies is doing so from inside South Africa and Australia and from a South African perspective is conducting its underlying activity on a continuous or regular basis.

The application of the 'connection to Australia' requirement in the case of a foreign supplier is not as simple. In this scenario, the supply will only be connected to Australia if the server hosting the virtual world is in Australia and thereby creates a permanent establishment for the foreign supplier. This method of connecting the supply of a foreign person to Australia is similar to the South African 'in, or partly in, South Africa' requirement based on the place of supply argument.

It was however indicated above that the place of activities argument is more accurate than the place of the supply argument. Based on this it may appear that where a foreign supplier supplies services in a virtual world hosted from a server in South Africa but conducts no activities in South Africa, the foreign supplier may not have an obligation to register for VAT in South Africa.



It was however contended in Chapter Two that where activities are conducted in a virtual world, the activity is conducted in two places. The place where the person controlling the avatar is situated and the place where the server is located. It follows that the place of activities argument therefore also encompasses the situation where the supplier is foreign and does not physically conduct any activity in South Africa but where the server is in South Africa.

Both the South African and Australian registration methods appear not to provide for the collection of VAT where a service is consumed in the relevant country and the supplier of the service conducts no activity in the relevant country or the server hosting the virtual world is not in the relevant country.

### **3.2.1.3 *Enterprise and threshold requirement***

As mentioned by Millar and McCarthy (2012:32), a person should not only have a GST turnover but should also be carrying on an enterprise in order to be liable for GST registration. An enterprise is defined as an activity or series of activities done in the form of a business or in the form of an adventure or concern in the nature of trade or on a regular and continuous basis in the form a lease, license or other grant of an interest in property.

The definition of an enterprise clearly requires an activity to be in the form of a business or in the nature of trade. Where a person conducts a business of the sale of software through the internet or conducts a business in a virtual world, it is considered that that person is conducting a business as envisaged in the definition of enterprise. However, determining what a business is and the distinction between a business and a private recreational pursuit falls outside the scope of this research.

A person will be required to register for Australian GST only if that person's GST turnover exceeds \$75,000 (Australian Taxation Office, not dated).

The question in the context of the Australian GST Act therefore is also when it should be determined whether the threshold has been reached. It may be concluded that the Australian GST Act will also follow the internal viewpoint discussed above based on the

fact that the consideration requirement from an Australian point of view is also satisfied inside the virtual world as stated by Walpole and Gray (2010:57).

Both the South African vendor registration method and the Australian registration method require the supplier to have reached a certain value of supplies before registration becomes compulsory. E-commerce and transactions in virtual worlds pose no obstacle for the threshold requirement in either country.

The definition of an enterprise in the GST Act is somewhat different to the relevant component of the enterprise definition in the VAT Act. While the GST Act appears to include purely business operations, the VAT Act on the other hand includes any activity that is not necessarily a business but which is also not a hobby or recreational pursuit. Accordingly, the VAT Act appears to be more lenient as to what it considers an enterprise to be.

### **3.2.2 The reverse charge mechanisms**

Millar and McCarthy (2012:29) state that there are two types of reverse charge mechanisms in terms of the GST Act. These are the voluntary reverse charge and the compulsory reverse charge.

Millar and McCarthy (2012:30) continue to mention that the voluntary reverse charge mechanism applies to supplies that are connected to Australia and to which the normal rules would otherwise apply. The application of this reverse charge mechanism however only applies to the supply of goods from a foreign supplier to a local GST registered recipient (Millar and McCarthy, 2012:30).

The compulsory reverse Charge mechanism should therefore not find application in the context of e-commerce and transactions in virtual worlds since the items supplied cannot be classified as goods.

According to Millar and McCarthy (2012:30) the compulsory reverse charge mechanism applies where “the following conditions are met:

- (a) the supply:
  - (i) is a supply of “services” (i.e. of something other than goods or real property);
  - (ii) is not connected with Australia; and
  - (iii) is made for consideration; and
- (b) the recipient of the supply:
  - (i) is registered (or required to be registered) for GST; and
  - (ii) would not be entitled to a full input tax credit for the acquisition of the “services” if the supply were a taxable supply; and
- (c) The supply is neither GST-free nor input taxed.”

It therefore stands to be determined whether e-commerce and supplies in virtual worlds could satisfy the requirements of the compulsory reverse charge mechanism.

In the case of electronic commerce and supplies in virtual worlds, the items being supplied are services and therefore the first requirement of the reverse charge mechanism is satisfied. However, in the case of e-commerce, the supply will be connected to Australia through the provisions of division 85 of the GST Act if the service is consumed in Australia and therefore this reverse charge mechanism does not apply to e-commerce.

Supplies in virtual worlds will however not be connected to Australia if the person making the supply in the virtual world is not doing so from inside Australia or through a permanent establishment inside Australia. In the context of virtual worlds, a foreign supplier can only be making a supply through a permanent establishment inside Australia if the server from which the virtual world is hosted is inside Australia. Where the supply is not connected to Australia, supplies in virtual worlds therefore satisfy the consideration requirement of the reverse charge mechanism.

It has been established above that supplies in virtual worlds are for a consideration as envisaged in the GST Act and therefore this requirement of the reverse charge mechanism is satisfied in the case of transactions in virtual worlds.

A further requirement of the compulsory reverse charge mechanism is that the recipient of the supply must be registered for GST. It appears therefore that the compulsory reverse charge mechanism is not aimed at final consumption of services in Australia. It follows that where a non-Australian resident supplies a service in a virtual world to a final consumer in Australia, the compulsory reverse charge mechanism does not apply, even though final consumption takes place in Australia. Walpole (2008:11) confirms this conclusion when he states that the reverse charge mechanism does not apply to “unregistered enterprises.”

Walpole and Gray also conclude (2010:58) that the supplies from a non-Australian resident to an Australian resident in the case of transactions in virtual worlds fall outside the application of the reverse charge mechanism.

The compulsory reverse charge mechanism in Australia, unlike the South African self-assessment method, appears not be aimed at final consumption. In addition, the Australian compulsory reverse charge mechanism, unlike its South African counterpart, does not appear to provide for the shortcomings of the Australian registration method. While the South African vendor registration may fail to bring supplies from a non-resident to a resident into the South African VAT net, the South African self-assessment would, irrespective of whether the activities or place of supply argument is followed under the vendor registration method.

This is not the case under the Australian legislation. Where a foreign supplier in the case of the GST Act, supplies virtual items to a non-GST registered Australian recipient, the reversed charge mechanism would not ensure that GST is collected.

### **3.3 THE AUSTRALIAN GST COLLECTION METHODS SUMMARISED**

The GST Act contains essentially two GST collection methods. A registration method and reverse charge mechanism. The requirements of the registration method effectively ensure, through division 85 of the GST Act, that GST is collected on e-commerce transactions where consumption takes place in Australia.

In the case of transactions in virtual worlds, the registration method effectively provides for the registration of suppliers situated inside Australia. However, where the supply is not connected to Australia in any way the registration method fails to bring consumption of virtual services in Australia into the GST net.

The compulsory reverse charge mechanism also does not appear to bring final consumption from a non-Australian supplier to an Australian supplier into the GST net because the recipient may not be registered for GST.

### **3.4 CONCLUSION**

Both the South African VAT Act and the Australian GST Act contains a registration method and a self-assessment or reverse charge mechanism for the purpose of collecting VAT and GST. The requirements of the registration methods employed in both countries are very similar. Their application to the e-commerce and transactions in virtual worlds yielded similar results with the following notable exceptions:

The GST Act contains specific provisions in Division 85 of the GST Act to deal with e-commerce transactions. The principle of the specific provision is that if the electronic item is consumed in Australia, the supply will be connected to Australia. This specific provision overcomes several potential issues with trying to connect the supply made by foreign supplier to an Australian resident in the current context.

These issues were highlighted where a foreign supplier of a virtual item supplies the virtual item in a virtual world to an Australian recipient. These supplies will only be connected to Australia if the underlying virtual world is hosted from a server located inside Australia since the special dispensation in division 85 does not apply to virtual world transactions. The compulsory reverse charge mechanism provides no relief unless the supply is made to a GST registered recipient.

While there are different views on the interpretation of the 'in, or partly in, South Africa' requirement of the South African vendor registration method, it is concluded that the activities argument is more accurate. In light of this argument, it appears that the vendor

registration method effectively ensures that VAT is collected on supplies made by South African residents of e-commerce and virtual items.

However, where the supplier is a non-South African resident and conducts no activities in South Africa and the server hosting the virtual world is not in SA, the supplies of that non-resident consumed in South Africa will not fall into the vendor registration method. However, where the vendor registration fails, the South African self-assessment method should ensure, in theory, that VAT is collected if the service is consumed in South Africa.

## CHAPTER 4

### SUMMARY, CONCLUSION AND VALUE OF THE STUDY

#### 4.1 INTRODUCTION

The purpose of this study was to compare the extent of the South African VAT collection methods' application to e-commerce and transactions in virtual worlds with the extent of the Australian GST collection methods' application to e-commerce and transactions in virtual worlds.

Chapter Two identified the South African VAT collection methods and applied its requirements to e-commerce and transactions in virtual worlds. In Chapter Three, the extent of the South African collection methods' application was compared against the extent of the Australian GST collection methods' application in the context of e-commerce and transactions in virtual worlds.

This chapter provides a summary of findings and conclusions and summary of contributions of the study. The chapter then provides suggestions for further research and concludes with concluding remarks.

#### 4.2 SUMMARY OF FINDINGS AND CONCLUSIONS

The South African VAT Act and the Australian GST Act both contain a registration method and a self-assessment or reverse charge mechanism for collecting the relevant consumption tax. The requirements of the registration methods are very similar with both Acts requiring there to be a supply of either a good or a service in return for which consideration is received. E-commerce and transactions in worlds would not escape the collection methods in either country solely because of these requirements of the registration methods (see paragraphs 3.2.1.1 above).

In addition to the above, both countries require some connection to it before the registration method applies. It is this connection requirement that may render these collection methods in both countries ineffective in the case of transactions in virtual worlds (see paragraph 3.2.1.2 above).

In South Africa, the connection requirement is achieved through the 'in, or partly in, South Africa' requirement. In Australia, it is achieved through a 'connection to Australia' requirement. There are two interpretations of the 'in, or partly in, South Africa' requirement of the South African vendor registration method in the current context. The place of activities argument was held to be more accurate (see paragraph 3.2.1.2 above).

It was concluded that if a person conducts activities in relation to e-commerce and transactions in virtual worlds in South Africa, the 'in, or partly in, South Africa' requirement is satisfied. In Australia a similar conclusion was reached. In the case of a supplier foreign to Australia and South Africa, neither country's registration method applied to transactions in virtual worlds unless the foreign supplier was, in the case of Australia, conducting his activities through a permanent establishment in Australia and, in the case of South Africa, was conducting some activity in South Africa. However, in Australia, a special dispensation exists for e-commerce that connects the supply to Australia if the service is consumed in Australia, irrespective of the place of supply (see paragraph 3.2.1.2 above).

Where the South African vendor registration method failed in the case of a foreign supplier, the self-assessment method prevailed to ensure that VAT is collected. However, where the Australian registration method fails, the reverse charge mechanism does not provide relief as widely as the South African self-assessment method does. (see paragraph 3.2.2 above).

It is concluded that Australia appears to have resolved the issues relating its connection requirement in the context of e-commerce but experiences similar issues than South Africa with its registration method in the case of transactions in virtual worlds. However, where the South African vendor registration methods fail, the self-assessment method effectively provides for the shortcomings of the registration method. This is not the case in Australia.



### **4.3 SUMMARY OF CONTRIBUTIONS OF THE STUDY**

The study highlighted that the potential problems with the application of the South African VAT collection methods in the context of e-commerce has been resolved in Australia. The study however indicates that the issues experienced in applying the South African VAT collection methods to transactions in virtual worlds are largely also experienced in Australia (see paragraph 3.2.1.2 above).

### **4.4 LIMITATIONS OF THE STUDY AND SUGGESTIONS FOR FUTURE RESEARCH**

This study did not attempt to determine whether a person is conducting an enterprise or whether the person is pursuing a hobby. The study was also limited to e-commerce and transactions in structured virtual worlds.

This study identified that there are two interpretations of the 'in, or partly in, South Africa' requirement in the context of this study. The place of supply argument appears to support the fact that a foreign supplier will only be required to register for VAT in South Africa if that person makes supplies through a permanent establishment in South Africa (refer paragraph 3.2.1.2 above). Future research could focus on whether the VAT Act contains such a requirement even though the definition of supply and enterprise in section 1 of the VAT Act indicates otherwise.

Research could also be conducted on whether the solution in Australia in the context of e-commerce can effectively be adopted in South Africa.

### **4.5 CONCLUDING REMARKS**

The VAT Act was drafted prior to the dawn of e-commerce and transactions in virtual worlds. Transactions in virtual worlds and e-commerce pose some potential problems for the South African VAT collection methods, problems also experienced with Australia's collection methods. However, in Australia the GST Act specifically provides for e-commerce transactions by connecting the supply of digital services to Australia if consumption of the digital service occurs in Australia.

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