# A CRITICAL EVALUATION OF PROPOSED METHODS TO COLLECT VALUE-ADDED TAX ON ELECTRONICALLY SUPPLIED SERVICES

by

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# ABSTRACT

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The boom of the internet economy and the smartphone explosion currently experienced in South Africa is making it increasingly more convenient for South African residents to purchase electronically supplied goods and services from suppliers located all across the globe with the mere click of a button. The increasing number of purchases online is making it almost impossible for the South African Revenue Service to collect the Value-Added Tax on specifically electronically supplied services purchased from foreign suppliers. It is further placing South African suppliers of similar goods and services in a disadvantaged position in respect of pricing when compared to foreign suppliers.

In the 2013 budget speech, the Minister of Finance indicated that the Value-Added Tax implications of the supply of digitised products by foreign suppliers are an area of concern. By July 2013 proposals were contained in the Draft Taxation Laws Amendment Bill to address this very problem.

The aim of this study is to critically evaluate the proposed methods to collect Value-Added Tax on electronically supplied services, as contained in the Draft Taxation Laws Amendment Bill through a detailed literature review and critical evaluation.

The literature review focuses on sections 7(1)(c) and 14 of the Value-Added Tax Act, the sections of the Value-Added Tax Act which currently regulates the collection of Value-

Added Tax on electronically supplied services, as well as the methods used in the European Union and New Zealand to collect Value-Added Tax and Goods and Services Tax on electronically supplied services.

The critical evaluation of the proposals identifies shortcomings and provides recommendations to overcome the shortcomings to ensure that the proposed changes will address the concerns and align South African legislation with global practices.

The study concludes that, although the proposed changes to the method to collect Value-Added Tax on electronically supplied services are a step in the right direction, there is still work to be done by legislators on the details of the proposals to ensure successful implementation in a South African environment.

**Key words**

- Electronically supplied services
- E-commerce services
- Imported services
- Internet economy

# OPSOMMING

## ’N KRITIESE EVALUASIE VAN VOORGESTELDE METODES OM BELASTING OP TOEGEVOEGDE WAARDE OP ELEKTRONIES GELEWERDE DIENSTE IN TE VORDER

deur

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Die enorme groei van die internet-ekonomie en die intelligente selfoon-ontploffing in Suid-Afrika maak dit al hoe meer gerieflik vir Suid-Afrikaanse inwoners om deur die blote druk van ’n knoppie, elektroniese goedere en dienste vanaf verskaffers dwarsoor die wêreld, te koop. Die toenemende aantal aanlyn-aankope maak dit byna onmoontlik vir die Suid-Afrikaanse Inkomstediens om die Belasting op Toegevoegde Waarde, op spesifiek elektronies gelewerde dienste aangekoop van buitenlandse verskaffers, in te samel. Dit plaas verder Suid-Afrikaanse verskaffers van soortgelyke goedere en dienste in 'n benadeelde posisie ten opsigte van die pryse in vergelyking met buitelandse verskaffers.

In die 2013-begrotingsrede het die Minister van Finansies aangedui dat die Belasting op Toegevoegde Waarde-implikasies op digitale produkte wat deur buitelandse verskaffers verkoop word aan Suid-Afrikaanse inwoners, 'n bron van kommer is. Teen Julie 2013 het die konsep Belastingwysigingswet reeds voorstelle om hierdie probleem aan te spreek, ingesluit.

Die doel van hierdie studie is om die voorgestelde metodes om Belasting op Toegevoegde Waarde op elektronies gelewere dienste soos vervat in die konsep Belastyingwysigingswet, krities te evalueer deur 'n gedetailleerde literatuurstudie en kritiese evaluasie.

Die literatuurstudie fokus op artikels 7(1)(c) en 14 van die Wet op Belasting op Toegevoegde Waarde, die artikels wat huidiglik die invordering van Belasting op Toegevoegde Waarde op elektronies gelewerde dienste reguleer en op die metodes wat tans in die Europese Unie en Nieu-Seeland gebruik word.

Die kritiese evaluasie van die voorstelle identifiseer tekortkominge en doen aanbevelings aan die hand om te verseker dat die voorgestelde wysigings die probleme sal aanspreek om Suid-Afrikaanse wetgewing in lyn te bring met internasionale praktyke.

Die studie kom tot die gevolgtrekking dat, hoewel die voorgestelde veranderinge aan die metode van Belasting op Toegevoegde Waarde in te samel op elektronies gelewerde dienste is 'n stap in die regte rigting is, wetgewers nog werk moet doen met betrekking tot die besonderhede van die voorstelle om suksesvolle implementering in 'n Suid-Afrikaanse omgewing te verseker.

**Sleutelwoorde**

- Elektronies gelewerede dienste
- E-handel dienste
- Ingevoerde dienste
- Internet-ekonomie

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# CHAPTER 1

# INTRODUCTION

## 1.1. BACKGROUND

The internet economy contributes approximately two per cent to South Africa's gross domestic product and is growing at a rate of approximately 30% per annum. Mobile networks report that an estimated 40 million South Africans are using mobile phones. This statistic represents the potential growth in the internet economy due to the smartphone explosion currently taking place in South Africa. It is expected that by the end of 2013, half of the ten million phones sold per annum will be smartphones. It is expected that by 2017 more than half of those using phones will be using smartphones – this means one in four people living on the African continent (Goldstuck, 2012:7).

Although the expansion of internet availability in South Africa and throughout the African continent boosts the economy and ensures that more South Africans are globally connected, the taxation policies to police internet related transactions have not emanated accordingly. The Value-Added Tax (hereafter referred to as VAT) and Goods and Services Tax (hereafter referred to as GST) regimes in many countries were developed before technology became advanced enough to make it possible to obtain any goods or services anywhere in the world with the mere click of a button. The availability and accessibility of electronically supplied goods and services are making it increasingly appealing to consumers, making locally supplied goods and services less competitive in a global market.

To date research has been conducted regarding whether or not certain purchases made online, fall within the ambit of the provisions of the South African Value-Added Tax Act (89/1991) (hereafter referred to as the VAT Act) (Johnston & Pienaar, 2013). There has also been research in Europe regarding what kind of services are imported electronically and where these services ought to be taxed (Parilli, not dated). Further studies have been done into the contrast between online and offline transactions and the difficulties experienced in an environment where electronic commerce is growing (Krensel, not

dated:4). These are assisting in the determination of exactly what imported electronically supplied services are and where these should be subject to VAT and possibly GST. The collection of VAT or GST on online purchases of goods is less problematic than that of services purchased online, seeing that goods will pass through a physical point of entry upon which the VAT or GST can be collected via the Customs and Excise activities of a country.

Following the original enactment of VAT and GST legislation, little attention has been given to the provisions included the legislation relating to the collection of VAT and GST on imported services. The VAT Act has only seen two minor changes to section 14: *Collection of VAT on imported services, determination of the value thereof and exemptions from tax* since 1991. South Africa has thus fallen behind from a tax perspective in respect of changes to the VAT legislation to address the impact the internet has on the imposition and the collection of VAT in an era where the internet economy is rapidly developing (Bardopoulos & Smuts, 2013:1).

Section 6.7 of the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013 (hereafter Explanatory Memorandum) explained that the growth in the internet economy together with the lack of changes to the VAT Act has left South African suppliers of electronic services in an uncompetitive position in comparison to foreign suppliers of similar goods. This is especially true for e-books suppliers like Amazon and Kalahari. South African suppliers of electronic services levy VAT at 14% where foreign suppliers do not. Foreign suppliers are perceived to be cheaper than South African suppliers and therefore preferred by consumers leading to economic inequality.

A further concern is that VAT is not being accounted for by South African consumers when downloading for instance movies, music, games and software, from foreign suppliers. This can be due to South African consumers being oblivious of such a statutory requirement, seeing the declaration of the VAT as voluntary or the authorities being unable to effectively police the current legislation (Bardopoulos & Smuts, 2013:1).

Research has shown that no formal assessment to quantify the loss due to the poor policing of the current provisions relating to imported services, which includes imported electronically supplied services, has yet been done (Bardopoulos & Smuts, 2013:1). One of the major causes of this is that the internet economy in South Africa is not being officially measured (Goldstuck, 2012:3). The loss due to the poor policing of the current provisions in the VAT Act are however deemed to be substantial and expected to increase in future as smartphones become increasingly popular in South Africa (Bardopoulos & Smuts, 2013:1).

In the research performed by Goldstuck (2012) for World Wide Worx it was reported by 2013 approximately five million smartphones will be sold. Livdigital Independent Research Editor reported that South Africans are among the top downloaders of mobile applications in the world. This report further indicated that direct revenue from paid-for apps, in-app purchases and subscriptions combined grew by nine per cent in quarter one of 2013 compared to quarter four of 2012 across four stores – Apple's App Store, Google Play, the Windows Phone Store and BlackBerry World (Livdigital Independent Research Editor, 2013).

If it is assumed that each of these new smartphone users downloads one application from one of these foreign stores mentioned above every month and that the average price of an application is $1, the total that only these new smartphone users spend on only mobile applications will total $60 million a year. This amount converted to Rand at an assumed average spot rate of $1 = R10 will be R600 million per annum. The potential loss in output VAT on only applications downloaded by only new smartphone owners will therefore amount to R85 million.

The above example shows that by only focusing on a small number of users and one specific type of electronically supplied service, the amount is already substantial. If the whole spectrum of users and all imported services are quantified the potential loss will be even greater.

This poor policing of the current methods to collect the VAT on imported services are therefore definitely a cause of concern.

In the 2013 budget speech, the Minister of Finance, Pravin Gordhan, also recognised the collection of VAT on digital goods and services as an area in the legislation that needs to be addressed. It was announced that Government proposes that all foreign businesses supplying e-books, music and other digital goods and services in South Africa be required to register as VAT vendors. This will be in line with legislation adopted by the European Union (hereafter referred to as the EU) in respect of such goods and services (National Treasury, 2013:21).

The Draft Taxation Laws Amendment Bill, 2013 (hereafter Draft TLAB), that was issued for comments on 4 July 2013, proposed changes to current VAT legislation to address the difficulties with collection of VAT on imported electronically supplied services. The fact that these proposals were made so shortly after the budget speech, indicates that National Treasury also views the problems surrounding the collection of VAT on imported electronically supplied services in a serious light.

## 1.2. STATEMENT OF PROBLEM

Collection of VAT on imported electronically supplied services is a complex topic and care should be taken to ensure that the changes are aligned with global VAT practice (South African Institute of Chartered Accountants, 2013:60).

In terms of the current provisions of the VAT Act the onus rests on the consumer of the imported services to declare and pay the VAT on the services purchased – the so-called reverse charge system. This collection mechanism is becoming more inefficient and is thus eroding the tax base (Johnston, 2011:34).

The TLAB which was published for commentary on 4 July 2013 contained proposed changes to the current VAT Act to address the shortcomings regarding the collection of VAT on imported electronically supplied services and indicated that the changes will be effective as from 1 January 2014.

The proposed changes may be a step in the right direction and supported by many South African suppliers of digital goods and services. However, there are many shortcomings which still need to be addressed in order to align the VAT Act with global VAT and GST practices before the regulations become effective. If the rules are not clear the chances of suppliers entering into tax avoidance schemes increase.

## 1.3. STATEMENT OF PURPOSE

The main purpose of this research study is to critically evaluate the methods as proposed in the TLAB to collect VAT in South Africa on electronically supplied service. It will be determined whether the proposed changes will address the shortcomings in the current legislation and whether it will result in alignment of the VAT Act with global practices applicable in a South African environment. Shortcomings in the proposed methods will be identified and suggestions made to address these shortcomings.

## 1.4. RESEARCH OBJECTIVES

This study will be guided by the following research objectives:

- To critically evaluate and identify the shortcomings in the current provisions in the VAT Act relating to methods to collect VAT on imported electronically supplied services.
- To review legislation enacted in foreign countries to collect VAT and GST on imported electronically supplied services.
- To obtain an understanding of the proposed methods (as contained in the TLAB) to collect VAT on imported electronically supplied services.
- To critically evaluate the proposed changes to the VAT Act in order to determine whether these proposals address the shortcomings of the current legislation and are in line with global practices applicable in a South African environment.
- To identify possible shortcomings in the proposed methods to collect VAT on imported electronically supplied services and make recommendations to address these shortcomings.

## 1.5. IMPORTANCE AND BENEFITS OF THE PROPOSED STUDY

This research study will provide insight into the VAT and GST legislation in other countries and some of the difficulties experienced by these countries when the respective legislation was changed to address electronically supplied services in the different countries. It is necessary to understand the challenges that other countries faced when making and implementing changes and use these as guidelines when making changes to the South African VAT Act.

It is further significant as it determines whether the proposed methods will address all the current shortcomings in the VAT Act to collect VAT on imported electronically supplied services and be in line with global practices as applicable in a South African environment. It is necessary for the SARS and National Treasury to consider this before the enactment of the changes to prevent misuse of the new legislation and further erosion of the tax base.

South African suppliers of electronically supplied services will also benefit from the research study. If the proposals are enacted it will ensure a level playing field for South African suppliers of electronic services, making suppliers more attractive to local consumers.

The impact on foreign suppliers of electronic services will also be highlighted. Because the proposals will impact foreign suppliers significantly these suppliers should understand the obligations that will be placed on them by the VAT Act and how this will affect their businesses.

Local consumers of electronic services, for example downloads of e-books, music, games and applications for smartphones, will also be impacted by these changes as they will pay more for the these services when the proposals are enacted. The study will by the use of an example show how consumers will be influenced by the changes.

## 1.6. DELIMITATION OF THE RESEARCH

The focus of the study will be on business to consumer (hereafter referred to as B2C) supplies, i.e. services that are supplied directly to the consumer by the business. The study will therefore not include business to business (hereafter referred to as B2B) supplies, including special rules for intercompany and interdivision sales. The consumers that will be focused on are those who are not registered VAT vendors.

The study will further only address the output and not the input tax implications of electronically supplied services.

The VAT implications on South African suppliers of electronic services will not be discussed in detail, although there will occasionally be references to these. The focus of the study will be on the VAT implications of imported electronically supplied services.

The focus of the study will further be on transactions that take place in an online environment and is not aimed at addressing all possible transactions or the VAT implications thereof, that can occur in a virtual world.

Proposed amendments contained in the TLAB which was released for public comment were critically evaluated. Any subsequent changes to the TLAB that might occur before the enactment of these proposals were therefore not considered.

In discussion of the EU VAT legislation regarding the collection of VAT on imported electronically supplied services, the fact that the EU consists of many countries with different VAT rates and the problems surrounding this will be briefly mentioned. A detailed discussion on this will not be done because South Africa does not apply different VAT rates.

Lastly, the VAT and GST legislation on telecommunication services will not be discussed in detail, although there will be references to the definitions as applicable in the foreign legislation to illustrate the importance of defining electronically supplied services.

## 1.7. DEFINITION OF KEY TERMS

Key concepts or definitions used throughout this study are defined as

**Electronically supplied services**

Services supplied electronically are defined differently in the different tax regimes. The term 'electronically supplied services' was first introduced by the EU. This term is widely used when referring to services supplied using electronic means.

Her Majesty's Revenue & Customs (2003) (hereafter referred to as HRMC) broadly defined 'electronically supplied services' as:

- "….In the first instance is delivered over the internet or an electronic network (in other words reliant on the internet or similar network for its provision),
- the nature of the service in question is heavily dependent on information technology for its supply (in other words the service is essentially automated, involving minimal human intervention and in the absence of information technology does not have viability)."

A detailed discussion regarding electronically supplied services from an EU perspective will be included later in the literature review.

New Zealand did not define 'electronically supplied services' in the GST Act but indicated in the Government discussion document GST and Imported services: A Challenge in an Electronic Commerce Environment, 2001 (hereafter referred to as GST and imported services discussion document) that digitised products will be treated as services for GST purposes.

Clause 174(1)(d) of the TLAB proposes the introduction of the term 'e-commerce services' which is defined as: "… the supply of any services where the placing of an order and delivery of those services is made electronically". This will constitute the South African definition of 'electronically supplied services'.

**Imported services**

Imported services are defined in section 1 of the VAT Act as: “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.”

The focus of the study will therefore be on consumers who are not registered VAT vendors and who import electronic services for personal use.

**Imported electronically supplied services**

Imported electronically supplied services, for the purpose of this research study, refers to electronically supplied services purchased from a foreign supplier, i.e. a supplier who is resident or carries on business outside the country in which the services are consumed.

**Internet Economy**

The internet economy is the total access to and the use of, the investment in internet infrastructure and the total expenditure on internet activities in a country (Goldstuck, 2012:3).

**Services**

Section 1 of the VAT Act defines services as: “anything done or to be done, including the granting, assignment, cession or surrender of any right or the making available of any facility or advantage, but excluding a supply of goods, money or any stamp, form or card contemplated in paragraph (c) of the definition of ‘goods’.”

The following table defines abbreviations and acronyms that have been used in this document.

**Table 1: Abbreviations and acronyms used in this document**

| Abbreviation | Meaning |
|---|---|
| B2B | Business to business |
| B2C | Business to consumer |
| TLAB | Draft Taxation Laws Amendment Bill, 2013 |
| EU | European Union |
| Explanatory Memorandum | Section 6.7 of the Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013 |
| GST | Goods and Services Tax |
| GST Act | Goods and Services Tax Act, 1985 (Act No. 141 of 1985) |
| GST and imported services discussion document | Government discussion document GST and Imported services: A Challenge in an Electronic Commerce Environment, 2001 |
| HMRC | Her Majesty's Revenue and Customs |
| OECD | Organisation for Economic Co-operation and Development |
| RSA | Republic of South Africa |
| SAICA | South African Institute of Chartered Accountants |
| SAIT | South African Institute of Tax Practitioners |
| SARS | South African Revenue Services |
| USA | The United States of America |
| VAT | Value-Added Tax |
| VAT Act | Value-Added Tax Act, 1991 (Act No. 89 of 1991) |

## 1.8. SUMMARY

This chapter provided a brief background to the study and its significance for different stakeholders. The delimitations and the key definitions which will be used throughout the study were also defined.

The next chapter will consist of a literature review of South African and foreign VAT or GST legislation on imported electronically supplied services, focusing on current and proposed legislation.

# CHAPTER 2

# LITERATURE REVIEW

## 2.1. INTRODUCTION

In view of the background provided in Chapter 1, current legislation in the South African VAT Act as well as legislation of foreign countries with regard to imported electronically supplied services and the methods to collect the VAT or GST on those services will be analysed and critically evaluated in this chapter.

## 2.2. SOUTH AFRICAN VAT LEGISLATION

### 2.2.1. Background

Imposition of VAT on imported services is regulated by section 7(1)(c) of the VAT Act which reads: “Subject to the exemptions, exceptions, deductions and adjustments provided for in this Act, there shall be levied and paid for the benefit of the National Revenue Fund a tax, to be known as the value-added tax— … (c) on the supply of any imported services by any person on or after the commencement date, calculated at the rate of 14 per cent on the value of the supply concerned or the importation, as the case may be.”

Section 7(2) of the VAT Act carries on: “Except as otherwise provided in this Act, the tax payable … shall be paid by the recipient of the imported services.”

It is necessary to understand what is included in the scope of ‘services’ and ‘imported services’ as defined in the VAT Act before the current legislation is analysed and critically evaluated.

'Services' are very broadly defined in the VAT Act and include intangible property, anything a person does or anything that will not fall within the definition of 'goods' (Interpretation Note 70, 2013:13).

For a 'service' to be seen as an 'imported service' it must be delivered to a South African resident by a supplier who is a resident of or carries on business in a country other than South Africa. These services should furthermore be used by the resident for non-taxable supplies, for example personal use. In most cases, when a South African recipient purchases services online in a personal capacity from a foreign supplier, those electronic services will be for personal use.

Electronically supplied services are however not defined in the current VAT Act. It has been concluded by prior research that transactions taking place in virtual worlds, for example digitised products that are sold over the internet, will fall within the definition of 'imported services' (Johnston, 2011:16). It is therefore clear that 'imported electronically supplied services' will fall within the ambit of the definition of 'imported services' (as it currently stands in the VAT Act) and taxed in terms of the 'imported services' provisions of the VAT Act.

In terms of section 14(1) of the VAT Act the recipient of the imported services should furnish the Commissioner with a return and calculate and pay the VAT over to the Commissioner within 30 days after the time of the supply of the imported services.

Section 14(5) of the VAT Act provides five exemptions from VAT on imported services. For the purposes of this study the fifth exemption will be critically evaluated. This exemption provides that all supplies of which the value on the invoice does not exceed R100 shall not attract any VAT.

Section 7, read with section 14 is therefore currently the primary taxing sections for imported electronically supplied services. These sections may however not be sufficient to effectively collect VAT on imported electronically supplied services because certain of the elements upon which these sections are founded create shortcomings which need to be addressed and clarified.

### 2.2.2. Elements requiring clarification

It is clear that the current method to collect VAT on imported electronically supplied services is governed *inter alia* by the following elements. Each of these elements adds unique shortcomings to the current legislation and requires clarification:

- any person;
- VAT to be paid by recipient of the imported service;
- all supplies not exceeding R100 is exempt;
- VAT to be paid to the extent that such services are utilized or consumed in the Republic otherwise than for the purpose of making taxable supplies; and
- a return must be furnished and payment of the VAT made to SARS within 30 days.

Each of the above elements will now be discussed in detail in order to critically evaluate the reason why this element needs clarification in order to address shortcomings in the current legislation.

#### *2.2.2.1. Any person*

To understand the importance of 'any person' section 7(1)(c) of the VAT Act needs to be contrasted against the general charging section which states that 'any vendor' making a supply of goods or services in the furtherance of any enterprise should levy VAT at a rate of 14 per cent on such supply.

In terms of section 1 of the VAT Act a person includes: "any public authority, any municipality, any company, and any body of persons (corporate or unincorporated), the estate of any deceased or insolvent person, any trust fund and any foreign donor funded project". This entails that a person can be a natural person (as per the normal meaning of the word) and also includes all the above.

A vendor on the other hand, as defined in the abovementioned section, means: 'any person who is or is required to be registered under this Act'.

It is therefore clear that section 7(1)(c) of the VAT Act extends to beyond vendors to include any and all persons that import services, as opposed to section 7(1)(a) of the VAT Act which is only applicable to vendors. Therefore, even if a person is not registered for VAT, section 7(1)(c) may still be applicable to such person.

#### *2.2.2.2. VAT to be paid by the recipient of the imported service*

In a normal sales transaction of goods or services which are to be consumed in the Republic, the supplier of the goods or service, if a registered VAT vendor, will levy the output tax at a rate of 14 per cent and pay it over to the Commissioner. The VAT vendor will take the output tax into account when calculating its net position on the VAT 201 forms which are furnished to the Commissioner. The VAT vendor therefore acts as the agent of the Commissioner to collect the VAT on all services supplied and consumed in South Africa. The consumer will play no role whatsoever in the payment of the output tax to the Commissioner, apart from paying the VAT over to the supplier at the point of purchase.

For imported services the provision works counter intuitive. The so-called reverse charge is applied in respect of imported services. The recipient (defined as the person who is supplied in section 1 of the VAT Act) must pay the VAT over to the Commissioner and not the supplier. The responsibility therefore shifts from the supplier to the recipient (or consumer). This implies that even if the recipient is not a registered VAT vendor (as the case will be with B2C supplies) he or she becomes responsible for the payment of the VAT to the Commissioner. If the recipient is a vendor who will use the services for non-taxable supplies, the VAT must be included in the VAT 201 and thus brought into account in the calculation of the net VAT to be paid over to the Commissioner.

#### *2.2.2.3. All purchases not exceeding R100 are exempt from VAT*

All purchases exceeding R100 will attract VAT. If the recipient of an imported service however structures transactions in such a way that each transaction falls below the R100 threshold, the transaction would not attract VAT as this would be exempt in terms of section 14(5) of the VAT Act (Bardopoulos & Smuts, 2013:2).

Furthermore, imported services will be priced in foreign currency. Tax can be evaded by only entering into transactions when the Rand is stronger against foreign currency. This will result in a lower Rand value and given the time the transaction is entered into and the exchange rate on that day; the transaction may be worth less than the R100 threshold.

#### *2.2.2.4. VAT to be paid to the extent that such services are utilized or consumed in the Republic otherwise than for the purpose of making taxable supplies*

In contrast to the provisions of section 7(1)(a) of the VAT Act which states that VAT should be levied on all supplies that are made in the furtherance of an enterprise, VAT on imported services are only levied to the extent that the service will not be used for the making of taxable supplies. Therefore, again a counter intuitive provision as one would expect output tax to be charged on all taxable supplies made.

The reason for this is that the recipient will be able to claim the input tax if the services will be used in the making of taxable supplies, leaving the recipient in a tax neutral position (Badenhorst, 2006). This provides a short cut for VAT treatment in respect of the import of services. The Vendor will not pay the VAT but will also not receive a corresponding input deduction.

This provision further indicates that the provisions are primarily aimed at taxing recipients who are not registered VAT vendors and are therefore aimed primarily at tax B2C supplies.

#### *2.2.2.5. A return must be furnished and payment of the VAT made to SARS within 30 days*

The recipient of imported services must complete a form (the VAT 215 form: Return in respect of imported services by a recipient that is not registered as a vendor) for every transaction entered into for the import of services. The return and payment must be made within 30 days of the earlier of the date on which the invoice was issued by the supplier or recipient or the date on which any payment was made by the recipient. The VAT 215 must be submitted and the payment made at the recipient's nearest SARS branch.

Currently the VAT 215 cannot be completed online and payments cannot be made via electronic funds transfer as is the case with personal income tax through the e-filing system. Furthermore, the recipient of the imported services has to complete a VAT 215 and declare the output VAT for every transaction. This will mean that an additional administrative burden is placed on the recipient seeing that the recipient needs to physically go to a SARS branch to declare and pay the VAT every time a service is imported. This could mean multiple times during a tax year in comparison with personal income tax which is only done once during each tax year.

### 2.2.3. Critical evaluation

The first problem with imported services is that there is no physical passage through a place of entry as there is for the importation of goods. The services can be acquired and consumed without any SARS official having any knowledge thereof. The honesty of the recipient of the imported service drives the method to collect VAT under the current legislation. However, in many cases the recipient will not even be aware of the fact that VAT should be declared on the importation of services or may think that such declaration is voluntary.

The second concern arising from the current legislation is that the VAT should be paid by the recipient, who can be any person, importing the services. Due to anonymity when transactions are taking place in an online environment as with electronically purchased services, it will be difficult for SARS to track the recipient of a specific electronic service, therefore making the policing of the current provisions almost impossible. If these provisions in the current VAT Act are to be strictly policed, it will no doubt be at a substantial cost for SARS.

If the cost that needs to be incurred to ensure compliance exceeds the benefits derived from the collection of the VAT on imported services, economy of collection is not achieved by the current legislation. If the opportunity cost of the collection cost is also taken into account, it is probable that the cost to effectively police the current legislation will exceed the benefits flowing to the fiscus.

The third concern with the current provision is the fact that the recipient needs to declare the VAT on every transaction and pay it at a SARS branch. Research done by Doing Business found that the use of an online filing and payment system reduces compliance time. Furthermore, streamlining the compliance process and reducing the time needed to comply will result in a more efficient VAT system (Doing Business, 2012). The fact that the VAT 215 and payments are still a manual process is therefore a further reason for non-compliance with the current regulation surrounding the declaration of VAT on imported services. The current method for declaration for payment is therefore not convenient for the recipient.

The fact that the current provisions are poorly policed will give foreign suppliers a competitive advantage over local suppliers who are required to levy VAT on services sold to consumers (Bardopoulos & Smuts, 2013:1). This is because consumers will perceive services offered by foreign suppliers to be cheaper than those offered locally. The current methods to collect VAT on imported services will therefore have an impact on the economic decisions of consumers and do not enhance a neutral tax system.

Another concern is that the R100 exemption could easily lead to consumers structuring their transactions in such a way to avoid paying VAT. For example, a consumer could do three transactions of R80 each instead of one transaction of R240 in order to utilise the exemption seeing that the exemption applies to individual transactions. The greater the chance for tax evasion, the less likely the tax system will be one that reflects equality.

The following example explains the current method for collection and the abovementioned concerns in a practical manner:

A twenty-four year old who is the owner of an iPhone downloads an application for the iPhone from the iStore available on the mobile device. This person is a general man on the street and has no in-depth knowledge of any taxation regulations. He or she earns less than the threshold to pay income tax and therefore SARS will have no record of tax payments made by this person. The application being downloaded costs $30, being R300

(converted at an assumed average spot rate of $1:R10). The person uses his or her credit card details to make the payment.

An application will fall within the definition of 'imported electronically supplied services' (i.e. being supplied over the internet, heavily dependent on information technology and by a foreign supplier to a South African resident). It will therefore be taxed in terms of the provisions applicable to 'imported services'.

The twenty-four year old will be the recipient of the imported service – he or she will be the one to whom the supply is made and who will enjoy (consume) the benefits of the application installed on the mobile device. Assuming this person is not a vendor, he or she will still fall within the definition of any person and will therefore have to complete and submit a VAT 215 and pay the VAT at the nearest SARS branch within 30 days. The chances of this happening are, however, very slim due to the following reasons:

- A person without any knowledge of the detailed regulations regarding the importation of services will not be aware of the responsibility he or she has to declare the imported service and pay the output tax over to the Commissioner. Even if the person was aware, the fact that the VAT 215 return and the payment of the VAT needs to be made at a SARS branch and cannot be done online, makes it even more unlikely for the recipient to declare and pay the VAT.
- The Commissioner will not have any record of this person seeing that he or she is not required to be registered for income tax and therefore has no way of tracing any payments made using a credit card back to this individual to prove that the service has been imported.
- The exemption in terms of section 14(5)(e) of the VAT Act will not apply to this purchase seeing that the purchase price exceeds R100 (i.e. R300).

The foreign supplier of the application (i.e. iStore) will have no obligation towards SARS whatsoever.

From the above example and analyses thereof, it is clear that the probability that SARS will in fact be able to collect the VAT from the person is highly unlikely, although in terms of

the VAT Act this should be paid over to the Commissioner and form part of the national revenue. Instead the tax base is being eroded.

### 2.2.4. Conclusion

Based on the evaluation of the current legislation in this chapter and given the rapid advances in technology making imported electronically supplied services more readily available, it will become almost impossible for SARS to police the current provisions in the VAT Act to ensure the collection of the VAT on imported services and especially imported electronically supplied services.

The Minister of Finance therefore rightfully identified this legislation in the 2013 budget speech as an area that requires urgent attention.

## 2.3. INTERNATIONAL GST AND VAT LEGISLATION

### 2.3.1. Background

This part of the literature review provides a detailed review of international legislation to collect the VAT and GST on imported services and especially imported electronically supplied services. The review first explains why the EU and New Zealand were selected for review and why certain other countries were not selected. Thereafter a detailed review of the EU and New Zealand's VAT and GST legislation will follow.

### 2.3.2. Countries considered

In 2002 the EU became the frontrunner in respect of the methods to collect the VAT and GST on imported services and more specifically imported electronically supplied services. Furthermore, in the budget speech the Minister of Finance indicated that he will refer to the methods implemented by the EU for the collection of VAT on imported electronically supplied services (National Treasury, 2013:21). This was further confirmed in the Explanatory Memorandum indicating that the proposed changes are aiming to align the

principles with those laid down by the Organisation for Economic Co-operation and Development (hereafter referred to as the OECD).

Although South Africa is not a member of the OECD, South Africa has a working relationship with the OECD and therefore follows the OECD guidelines to certain extent (Deloitte & Touche VAT Division, 2013:10). It is therefore important to understand what changes the EU have made to its legislation, as well as how the changes have been implemented, before the proposed changes to the South African VAT Act can be critically evaluated.

The South African VAT Act is based on the GST system of New Zealand. It is therefore necessary to understand how New Zealand's law makers are treating GST on imported services and especially imported electronically supplied services. If nothing is being done by New Zealand in respect of this, the lack of change in itself may be fundamental in understanding the proposed changes to the VAT Act.

In 2011 Norway became the latest country to tax imported electronically supplied services supplied by a non-resident business to local consumers. This follows Switzerland that made similar changes in 2010 (Deloitte Tax LLP. 2011:1). Although not part of the EU, the changes made by Norway and Switzerland are in line with the principles of the EU and therefore these countries were not further reviewed.

Israeli authorities have also recently taken the view that where a foreign supplier supplies services to an Israeli resident the definition of 'foreign supplier' is not met. This interpretation will in turn require companies which supply electronic services to register for VAT in Israel (Bibi & Yitshaki, 2012:29). This has however not yet been finalised and will therefore not be further discussed, but does indicate that there is a growing concern about the collection of VAT on imported electronically supplied services.

Prior to the changes that the EU made to its VAT legislation regarding electronically supplied services in 2002, most research on the taxation of e-commerce had been undertaken by the United States of America (hereafter referred to as USA). It is suggested by some scholars that this research conducted might have been a catalyst for USA to

impose the moratorium on taxes on internet businesses (Downer, 2001:59). The Internet Freedom Act originally imposed a three-year moratorium on the taxes on internet businesses on state and local level in 1998, but this moratorium has been extended three times by the Senate. The expiry date for the current moratorium is 1 November 2014.

In August 2013 a proposal was however made to permanently extend the current ban by introducing the Internet Tax Freedom Forever Act. This was widely applauded by the internet industry in the USA as it is believed that the permanent ban will protect consumers and small businesses from burdensome taxes on internet purchases (Eggerton 2013). Although this is an interesting school of thought it is in no way aligned with the direction in which South Africa is currently headed in respect of electronically supplied goods and services and therefore the USA's legislation was also not further reviewed.

The Canadian Revenue Authority has also provided definitions for electronically supplied services supplied by foreign suppliers and for the registration of non-resident suppliers supplying these services in Canada (Deloitte & Touche VAT Division, 2013:10). The definitions and treatment are however very similar to those of the EU and New Zealand. Furthermore, Canada is a larger country than South Africa and has a more stable economic environment. Therefore, although Canada also has specific regulation in relation to electronically supplied services, a detailed evaluation of the Canadian GST on imported electronically supplied services will not be performed.

The BRIC countries (Brazil, Russia, India and China) were also considered seeing that these are also developing economies like South Africa, as opposed to countries in the EU and New Zealand with developed economies. However, based on limited research performed on the legislation of these countries, little to no changes has been made to address VAT and GST implications on imported electronically supplied services. Access to detailed information with regard to legislation in India and China presented further challenges. South Africa is also significantly smaller than these countries. Therefore the VAT and GST legislation of these countries will not be reviewed in detail.

The legislation applicable to the collection of VAT and GST in EU and New Zealand respectively, will now be reviewed in detail in the next sections.

### 2.3.3. European Union

#### *2.3.3.1. Background*

Before the adoption of Council Directive 2002/38/EC44 of 7 May 2002 (hereafter Directive 2002/38/EC44), the place of supply of services was determined by article 9(1) of Directive 77/388/EEC (hereafter referred to as the Sixth Directive). In terms of this Directive, the place of supply of services was where the supplier had established his business, had a fixed establishment or where he had his permanent address or usually resided (European Union, 1997). These general provisions therefore taxed the supply of imported electronically supplied services, where the supplier was established, disregarding where the services were consumed (Van der Merwe, 2004:577). Imported electronically supplied services were treated the same way as any other service from a VAT perspective.

Before 2002 there was therefore no means of taxing supplies made by suppliers who do not have a fixed establishment in the EU from where the services are being supplied, leading to EU suppliers being less competitive compared to non-EU suppliers. This was seen as a problem that could potentially lead to losses for the European fiscus due to decline in VAT collection (Johnston, 2011:31).

The VAT implications of imported electronically supplied services from non-EU countries to EU-established consumers was dramatically reformed in 2002 primarily by Directive 2002/38/EC44 which was adopted on 7 May 2002 and took effect on 1 July 2003 (Parilli, not dated:10). The EU made the necessary changes to the legislation to address the shortcomings identified prior to 2002.

The legislation in place after 2002 will now be reviewed.

#### *2.3.3.2. Current legislation*

During the review of the VAT legislation currently in place with regard to the collection of VAT on imported electronically supplied services the following three elements will be discussed in detail because these elements drive the method for the collection of the VAT:

- definition of electronically supplied services;
- place of supply of electronically supplied services deemed to be in the EU; and
- declaration and payment of the VAT by non-EU suppliers by electronic means.

*Definition of electronically supplied services*

Annex II of Council Directive 2006/112/EC of 28 November 2006 (hereafter referred to as Council Directive 2006/112/EC) provided an indicative list of imported electronically supplied services. This list was also provided in Annex L of Council Directive 2002/38/EC of 7 May 2002 (hereafter referred to as Directive 2002/38/EC), although the heading read 'Illustrative List'.

This list included:

1. "Website supply, web-hosting, distance maintenance of programmes and equipment.
2. Supply of software and updating thereof.
3. Supply of images, text and information and making available of databases.
4. Supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events.
5. Supply of distance teaching."

This 'Indicative List' replaced Annex I of Regulation (EC) No. 1777/2005 which provided a more extensive list (Deloitte & Touche VAT Division, 2013).

Parilli (not dated) explained that although the contents of the list are clear and still cover all the aspects which were included in the previous Annex I, the problem may lie with identifying when a service is expected to be an electronically supplied service. The

Directives dealing with the definition of imported electronically supplied services has not yet brought in specifications for how the supply should take place. The items mentioned in the list can be delivered through the internet, over other networks or by using other delivery systems like Bluetooth.

Other critics argued that the list does not provide a comprehensive definition and that due to the rapid evolution of the internet economy and e-commerce there may soon be many services that will fall outside the scope of this list (Basu, 2002:19).

Van der Merwe (2004) however explained that "The EU deliberately refrained from defining imported electronically supplied services by means of a prescriptive list, because of the disadvantages of such a method: it creates problems in defining each type of service on the list, runs the risk of quickly becoming outdated, and creates a fence around which avoidance and tax planning can occur."

Even though there are different views on the comprehensiveness of the 'Indicative List' which forms the basis for defining imported electronically supplied services, it is nonetheless being addressed and forms a foundation which can be built upon.

Council Directive 2006/112/EC further defined 'telecommunication services' as "…services relating to the transmission, emission or reception of signals, words, images and sounds or information of any nature by wire, radio, optical or other electromagnetic systems, including the related transfer or assignment of the right to use capacity for such transmission, emission or reception, with the inclusion of the provision of access to global information networks."

Although the VAT implications of telecommunication services will not be reviewed in detail as part of this literature review, it is important to note that the EU saw the need to have separate definitions for 'electronically supplied services' and 'telecommunication services'.

*Place of supply of imported electronically supplied services*

In 2002 article 1 of the Directive 2002/38/EC amended article 9 of the Sixth Directive to add paragraph 2(f) to the aforementioned article: "The place where services referred to in the last indent of subparagraph (e) [electronically supplied services] are supplied when performed for non-taxable persons who are established, have their permanent address or usually reside in a Member State, by a taxable person who has established his business or has a fixed establishment from which the service is supplied outside the Community or, in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, shall be the place where the non-taxable person is established, has his permanent address or usually resides."

The place of supply rules were thus amended by the addition of article 9(2)(f) to the Sixth Directive to deem the place of supply of imported electronically supplied services to be where the consumer is located – thus where the services are consumed. These principles were supported by the OECD guidelines (Johnston, 2011:34).

This amendment therefore forced a non-EU supplier to register for VAT in the EU if electronic services are supplied to non-taxable persons in any of the member states in the EU as from 1 July 2003. This moved the obligation for the payment of the VAT from the non-taxable EU consumer to the non-EU supplier.

EU authorities experienced three difficulties with these changes:

Firstly, it is difficult for the authorities of the different Member States to identify non-resident suppliers (Van der Merwe 2004:582). If a non-resident supplier is not identified by the authorities, VAT will never be collected on the sales made by such a person and the tax base will still be eroded. This being said, in 2003 The Financial Times still reported that "UK Customs and Excise reckon that 90 per cent of business-to-business transactions by value and 80 per cent of business-to-consumer trades will comply the EU's VAT on e-commerce directive" (Leyden, 2003).

Secondly, it is difficult for the non-EU supplier to determine where the services will be consumed and whether the consumer is a non-taxable private person or a taxable business. The ability of the non-EU supplier to make the above determinations is inherent to the success of the system (Van der Merwe, 2004:582). The US Council for International Business also expressed the concern that proving the location of the consumer may prove difficult and can result in greater compliance costs for non-EU suppliers (Basu, 2002:18).

The third difficulty related to the rate which the non-EU supplier should charge. Based on the place of supply rule for imported electronically supplied services, VAT is levied at the rate applicable to the member state where the consumer is located, which may range between 15 per cent and 25 per cent. As explained by Basu (2002:17), in order to properly assign the taxes the non-EU supplier therefore needs to keep track of their customer's location. This problem will however be unique to the EU when VAT on imported electronically supplied services is collected from non-EU suppliers due to multiple countries forming part of the EU. South Africa levies VAT at a rate of 14 per cent in terms of section 7 of the VAT Act, regardless of where in the country the services are consumed.

*Declaration and payment of the VAT by non-EU suppliers*

Based on the above, to account for VAT where the electronic services are consumed, the non-EU supplier would have to register for VAT in every Member State in which such services are supplied. Due to this placing an administrative burden on non-EU suppliers the special scheme (so called 'one-stop' scheme) for imported electronically supplied services was introduced by the addition of article 26c to the Sixth Directive by article 1 of Directive 2002/38/EC.

In terms of the aforementioned, eligible non-EU businesses are given the option of registering electronically in a single Member State of their choice and accounting for VAT on their sales of imported electronically supplied services to all EU consumers on a single quarterly electronic VAT declaration which provides details of VAT due in each Member State (HMRC, 2003). The return shall be submitted and the payment of the VAT due made within 20 days following the end of the reporting period to which the return refers. In terms

of article 26c, the return must be submitted electronically every quarter regardless of whether electronic services were supplied in that quarter or not.

The fact that all administration takes place electronically and only once a quarter, eases the compliance burden slightly.

#### *2.3.3.3. Proposed changes*

As from 1 January 2015 the place of supply rules for all B2C supplies of electronically supplied services and telecommunication services will be the country where the recipient is established or usually resides, regardless of whether it is supplied by an EU or a non-EU supplier (Arthur Cox, 2011:1) This change will therefore primarily impact EU suppliers because non-EU suppliers are already required to account for the VAT in the member state where the recipient is established or usually resides. All suppliers of electronically supplied services and telecommunication services will then be permitted to discharge their VAT obligation using the so-called one-stop scheme.

The EU is further currently developing rules for e-commerce and a report on these recommendations is expected towards the end of 2013 (South African Institute of Chartered Accountants, 2013:60).

#### *2.3.3.4. Summary*

The EU correctly identified the supply of imported electronically supplied services by non-EU businesses as an area which needs to be addressed from a VAT perspective and the changes have now been implemented for more than ten years.

The important aspects addressed as part of these changes were:

- the definition of electronically supplied services, albeit only in the form of an indicative list;
- the determination of the place of the supply; and
- the implementation of administrative requirements to make the process more convenient and lift the administrative burden on foreign suppliers.

However, the success of this system is heavily reliant on two things: the ability to identify the consumer online and the ability of VAT authorities to trace non-compliant businesses. Although hints have been made that technology will eventually be used to make compliance easier, no changes have been made to current VAT legislation that provides concrete details of how compliance will be ensured. (Basu, 2002: 21.)

### 2.3.4. New Zealand

#### *2.3.4.1. Background*

Before 2001 most imported services, unlike imported goods, were not subject to GST in New Zealand. Imported services and imported goods were thus treated differently for GST purposes (Olding & Sussman, 2001:1).

In 2001 the New Zealand Government recognised that not taxing imported services poses a risk to the tax base and is contrary to the international framework for consumption taxes. The GST and imported services discussion document setting out proposed changes to New Zealand's Goods and Services Tax Act (141/1985) (hereafter referred to as the GST Act) was then issued. These proposed changes were subsequently adopted into the GST Act and provided specific rules for the collection of VAT on imported services. Telecommunication services and the GST treatment thereof were also amended as a result of these proposals.

These changes provided for two separate sets of rules; namely rules for imported services and rules for telecommunication services. For the purpose of this study a brief overview of the definition of telecommunication services will be provided, but no in-depth review of provision in the GST Act relating to telecommunication services will be done. The provisions applicable to imported services will be reviewed in detail.

#### *2.3.4.2. Telecommunication services*

Section 2 of the GST Act defines telecommunication services as: "Telecommunications services means the transmission, emission or reception, and the transfer or assignment of the right to use capacity for the transmission, emission or reception, of signals, writing, images, sounds or information of any kind by wire, cable, radio, optical or other electromagnetic system, or by a similar technical system, and includes access to global information networks but does not include the content of the telecommunication."

Content of telecommunication service is specifically excluded from the definition above. Content is defined in section 2 of the GST Act as "…signals, writing, images, sounds or information of any kind that are transmitted, emitted or received by telecommunications services".

It is therefore clear that the downloading of music, applications, games and so forth will be the content of telecommunication services. The provisions for imported services as explained in the next section will therefore be applicable to the content of telecommunication services.

#### *2.3.4.3. Imported services*

In terms of section 8(4B) of the GST Act services are treated as being supplied in New Zealand if:

- the services are provided to a New Zealand resident by a non-resident;
- the recipient will use the services to make less than 95% taxable supplies (i.e. using it to make non-taxable supplies); and
- the supply would have been taxable if made in New Zealand by a registered person in the course or furtherance of taxable activities.

Telecommunication services are specifically excluded from section 8(4B), but as stated above the content of telecommunication services will fall within the ambit of this section of the GST Act.

If a resident receives service as stated above, section 5B of the GST Act treats the service as being supplied by the recipient in the course or furtherance of a taxable activity carried on by the recipient, and GST at a rate of 15 per cent must be calculated on such a supply. The reverse charge mechanism is therefore being applied.

The taxation of imported electronically supplied services is therefore based on the following elements or principles; each of which will be briefly discussed:

*Definition of electronically supplied services*

Electronically supplied services are not specifically defined in the GST Act and will merely be included in the definition of services in section 2(1) of the GST Act (defining services as anything other than goods and money).

In the GST and imported services discussion document it was stated that there should be a clear definition of the services to which the reverse charge should apply. However, using a generic definition as opposed to a list of services to which the reverse charge would apply (other than the EU which provides a list of services), would remove the need to define each type of service on the list. Furthermore, as new types of services emerge with the development of technology, a list would have to be updated, resulting in constant changes.

It was however clarified in the GST and imported services discussion document that digitised products will be treated as services and therefore the reverse charge will be applicable to the importation of digitised goods. Digitised goods were defined in the GST and imported services discussion document as "…goods and services that are delivered by electronic means in digital form. These products can be delivered to a computer through the internet, by way of telephone or cable network, or by satellite."

'Telecommunication services' and 'content' were also defined, making it easier to identify electronically supplied services (Deloitte & Touche VAT Division, 2013:6).

Therefore, although electronically supplied services are not specifically defined, the need was recognised to include digitised products in the definition of services and to clarify what digitised products are.

*Place of supply of imported electronically supplied services*

In terms of section 8(4B) of the GST Act the services are deemed to be made in New Zealand if provided by a non-resident to a resident. This is consistent with the destination principle applicable to the supply of other goods and services in New Zealand taxing the services where it is consumed.

*Reverse charge mechanism*

In terms of the reverse charge a registered recipient of the imported services, which (as discussed) will include electronically supplied services must return the GST to Inland Revenue as if the recipient were the supplier of the services. The reverse charge will further only be applicable insofar the registered recipient acquires the services for purposes other than making taxable supplies (Olding & Sussman, 2001:1). This provision therefore makes this provision aimed at B2C supplies.

This mechanism is in many ways similar to the current method for collection of VAT on electronically supplied services in South Africa, but with one important difference: the reverse charge is only applicable to registered recipients and not to all recipients as per the VAT Act.

In terms of section 51 of the GST Act a person is required to register for GST if the taxable supplies made by that person exceeds NZ $60 000 in a 12-month period. This implies that a natural person (i.e. not a business who would generally be registered for GST) will be required to register for GST in New Zealand only if such a person purchases electronically supplied services in excess of NZ $60 000 in a 12-month period. A clear threshold is therefore applied by New Zealand in respect of the reverse charge mechanism (Deloitte & Touche VAT Division, 2013:9).

The GST and imported services discussion document explained that the registration of foreign suppliers was also considered as an option when the GST Act was changed to tax imported services. Two difficulties with this method were however highlighted. Firstly, that it would be difficult to enforce since the legislation would have to be enforced offshore. Secondly the fact that it would create compliance cost concerns for non-residents seeing that they would have to register and charge GST in New Zealand.

It was therefore concluded in the GST and imported services discussion document that "While it is feasible for an economic bloc (like the EU) [inserted] to implement such a system of taxation, it is questionable whether a country the size of New Zealand could unilaterally impose and enforce such a system."

The reverse charge mechanism was hence enacted and no changes to the GST Act have since been made to change the method for the imposition of GST on electronically supplied services.

#### *2.3.4.4. Summary*

New Zealand authorities correctly identified that the imposition of GST on imported services, which will include electronically supplied services, is becoming increasingly problematic and made changes to the GST Act to address these problems. These changes were made to ensure optimal effectiveness within New Zealand's environment and taking into account the size and resources of the country.

The important aspects addressed as part of these changes were:

- aiming to define electronically supplied services; and
- the fact that the GST registration threshold also applies regardless of who must register and account for the GST on the supply of imported electronically supplied services.

### 2.3.5. Conclusion

This chapter reviewed the legislation currently in place in in the EU and New Zealand to collect VAT and GST on electronically supplied services. From the review above of the legislation in these countries, it is clear the methods currently used to collect VAT and GST differs in the different countries. South Africa should therefore make changes that will address the unique South African environment, especially in view of the smartphone explosion currently being experienced in South Africa.

## 2.4. PROPOSED CHANGES TO THE SOUTH AFRICAN VAT LEGISLATION

### 2.4.1. Background

The TLAB proposed additions to the VAT Act to address the concerns rose in the 2013 budget speech with regard to digital goods and services. These proposals will be effective on all supplies made on or after 1 January 2014.

The Commissioner essentially wants to introduce a place of supply rule for e-commerce services as defined and seeks to address the current shortcomings in the VAT Act in respect of the method to collect VAT on imported services (South African Institute of Chartered Accountants, 2013:58).

However, the Explanatory Memorandum indicated that the reverse charge mechanism will remain as a backup to the new place of supply rules. This means that SARS can fall back on these current provisions of the VAT Act. If a foreign supplier of electronically supplied services does not register for VAT, the backup will therefore place the obligation on the recipient of the imported electronically supplied service to declare the VAT.

These proposals will now be discussed in order to understand the implications of the changes.

### 2.4.2. Proposed changes to VAT Act

The proposed changes to the VAT Act will require all foreign suppliers of e-commerce services to register for VAT in South Africa as it will be deemed that such a supplier is carrying on an enterprise in the RSA; regardless of the value of the supplies made. The VAT on the supplies will therefore be levied in terms of the general charging section (section 7(1) of the VAT Act) even though they are is cross-border supplies.

The proposals will make the following additions to the VAT Act; each of which will be briefly discussed in order to obtain an understanding of the change:

#### *2.4.2.1. Definition of e-commerce services*

Clause 174(1)(d) of the TLAB proposes the addition of the term 'e-commerce services' to section 1 of the VAT Act. The proposed definition is: "… the supply of any services where the placing of an order and delivery of those services is made electronically". This will constitute the South African definition of electronically supplied services.

The definition aims to define which services will fall within the scope of the new provisions to the VAT Act that will require foreign suppliers to register for VAT in South Africa and will include any service where the placing of the order and delivery of the service is made via electronic means.

#### *2.4.2.2. Definition of enterprise*

The definition of 'enterprise' in section 1 of the VAT Act will be amended in terms of clause 174(1)(e) of the TLAB to include the following sub-paragraph to the proviso in this definition: "(vi) the supply of e-commerce services by a person that is not a resident of the Republic— (aa) to a recipient that is a resident of the Republic; or (bb) where one or more payments to that person originates from a bank registered in terms of the Banks Act, 1994 (Act No. 94 of 1994);".

This addition to the definition of 'enterprise' establishes the place of supply of electronically supplied services and therefore deems the supply to have been made in South Africa.

However, to determine the place of supply is often problematic due to the customer's location being unknown and therefore a proxy for the location will be used (Explanatory Memorandum, 2013:93). The above addition also specifies the proxies as either residency in South Africa or payment for the service originated from a South African bank account.

The determination of the location of the recipient was one of the difficulties experienced by the EU when the new places of supply rules were introduced. The proposals aim to address this difficulty by the introduction of possible proxies for the consumer's location.

#### *2.4.2.3. Registration requirements*

Clause 187(1)(b) of the TLAB will amend section 20 of the VAT Act to include a sub-paragraph placing a liability on all suppliers of e-commerce services deemed to be carrying on an enterprise in the RSA, to register for VAT at the end of the month in which the e-commerce services are supplied.

The Explanatory Memorandum confirmed that a special compulsory VAT registration category with no monetary thresholds will be created by the above addition to section 20 of VAT Act.

In terms of proposed additions to section 15 of the VAT Act e-commerce suppliers will be allowed to register on the payment basis to help streamline compliance (Explanatory Memorandum, 2013:94).

#### *2.4.2.4. Requirement to issue a tax invoice*

In terms of the proposed addition of subparagraph 5B to section 20 of the VAT Act (per clause 185(1)(a) of the TLAB) the foreign supplier of e-commerce services will be required to provide the recipient of the service with a tax invoice. A tax invoice should at least contain the following information:

- the words ‘tax invoice’;
- the supplier’s name, VAT registration number address;
- a unique serialized number and the date of issue;
- description of the goods or services supplied; and
- the value of the supply with a clear indication of the amount of tax charged for the supply.

This may mean that foreign suppliers must design specific tax invoices for supplies made to South African consumers to be able to reflect all of the above information.

### 2.4.3. Impact of the proposed changes in legislation on consumers and suppliers

Using the same example as in paragraph 2.2.3 (the 24 year-old purchasing an application for his iPhone from iStore), the VAT treatment, should the proposals be enacted, will be:

- The application will be an ‘e-commerce’ service as defined because the application was ordered from his smartphone using the internet on his smartphone and was also delivered directly to his smartphone using the internet.
- The person ordinarily resides in South Africa and is therefore a South African resident. The payment was also made with a South African credit card, i.e. from a South African bank account.
- Because the application falls within the definition of e-commerce service and both the proxies to determine the location of the consumer indicate that he is in South Africa, iStore (a foreign entity) will be deemed to be carrying on an enterprise in South Africa.
- iStore therefore has to register as a vendor in South Africa at the end of the month in which the application was sold to the 24 year-old.
- iStore must also issue a tax invoice to the 24 year-old for the application sold to him.
- The price of the application will also be impacted. An application which cost $30 will now be inflated with the VAT amount thereon because the iStore would still want to sell the product for a net amount of $30. The consumer will now pay $34.2 for the same application – R42 (assuming an exchange rate of $1 = R10) more than before. iStore, now acting as an agent for SARS, will have to pay R42 VAT over to SARS.

- The consumer will no longer have a direct obligation towards the Commissioner for the payment of the VAT. (It should however be kept in mind that the reverse charge mechanism – placing the obligation on the buyer again – will apply should iStore not register for VAT due to the so-called backup, as explained earlier in paragraph 2.4.1.)

The example above shows that the obligation for the declaration of the payment now effectively shifts from the consumer to the supplier.

### 2.4.4. Conclusion

SARS and National Treasury have correctly identified that the current legislation falls short of the global legislation in respect of the methods to collect VAT on electronically supplied services. Proposals were made to attempt to address the shortcomings in the current legislation. However, the successful implementation of these proposals will be heavily reliant on SARS's ability to enforce compliance.

## 2.5. CONCLUSION

In this chapter the current legislation regulating the methods to collect VAT or GST on imported electronically supplied services in South Africa and foreign countries was reviewed and critically evaluated. An understanding was further obtained of the proposed changes to the VAT Act to address the shortcomings in the current legislation in respect of the methods to collect imported electronically supplied services.

The following table summarises the differences between the current legislation as applicable in South Africa, the EU and New Zealand as well as the proposed changes to the South African VAT Act.

**Table 2: Summary of differences in legislation**

| Element / requirement | South Africa current legislation | EU | New Zealand | South Africa proposed legislation |
|---|---|---|---|---|
| Electronically supplied services defined | No – falls within the scope of 'imported services' | Yes | No – falls within the scope of 'imported services' however, 'telecommunication services' is defined providing means to identify what electronically supplied services are | Yes – but defined as e-commerce services |
| Collection method | Reverse charge | Registration of non-EU suppliers by utilisation of place of supply rules | Reverse charge | Registration of foreign e-commerce suppliers by introduction of a place of supply rule |
| Responsible for declaration and payment | Any recipient | Supplier of the service | Only registered recipients | Supplier of the service |
| Applicable to B2C or B2B supplies | Primarily B2C | B2C | Primarily B2C | B2C and B2B |
| Threshold in place | Exemption for all transactions less than R100 | None | Yes – NZ $60 000 | None |

The next chapter will explain the research design and methods used in this research study.

# CHAPTER 3

# RESEARCH DESIGN AND METHODS

## 3.1. INTRODUCTION

In the previous chapter the VAT and GST legislation governing the collection of VAT and GST on electronically supplied services was reviewed and critically evaluated. This chapter will now provide a detailed explanation of the research design and method before the proposed changes to the VAT Act is critically evaluated in Chapter 4.

## 3.2. RESEARCH DESIGN

The research approach followed in this study is qualitative in and will adopt the form of an empirical study with a literature review component.

Empirical study refers to research where the researcher collects new data or where existing data, collected by a person other than the researcher for another study, is re-analysed (Babbie & Mouton, 2001:75). New data is referred to as primary data and existing data as secondary data.

Primary data sources and primary sources should be contrasted, but both will provide first-hand, unmediated information. Primary data sources are those which are collected first-hand by the researcher, whereas primary sources may be published or unpublished information obtained by the researcher. This data is often created at the time of an event. By contrast, secondary data refer to sources that already exist and are considered to be non-original. These data sources are nonetheless quite valuable (Persaud, 2012).

As part of this study, primary and secondary data sources were reviewed and critically evaluated.

The secondary data which will be used for this study includes inter alia published and enacted South African and international legislation together with various published commentaries thereon. The TLAB and the Explanatory Memorandum are further secondary data sources which are critically evaluated as part of this research study. These represent potential new legislation which has not yet been enacted in South Africa. The secondary data sources are all publically available.

In the design of the research two sources of primary data were considered. The one alternative was collecting data in the form of semi-structured interviews conducted through the use of standardized questionnaires sent to selected directors of a single firm (the firm would have been an auditing firm in South Africa). The second alternative was to obtain the commentary on the TLAB as submitted to National Treasury and SARS. These documents are written as a result of the TLAB being published for commentary (i.e. created at the time of the event) and therefore represent primary data.

The two alternatives were evaluated and the latter was selected as the more reliable source of primary data. The commentary documents as prepared by the South African Institute of Tax Practitioners (hereafter referred to as SAIT) and the South African Institute of Chartered Accountants (hereafter referred to as SAICA) were obtained directly from the respective institutes' representatives and were used as the primary data sources in this research study. In addition to this, research conducted by the Deloitte & Touche VAT Division which was included as an annexure to the SAIT commentary, was obtained directly from the Deloitte practitioners who were involved in conducting this research.

The use of the commentary as the primary data source was chosen over the use of semi-structured interviews because:

- The commentary documents incorporate the views of various members of the respective institutes. According to communication with SAIT's head of technical policy and research on 3 September 2013, the submission made by SAIT incorporates the inputs of more than ten thousand tax practitioners. Based on a discussion with the project manager of tax for SAICA, on 13 September 2013, the commentary submitted by SAICA was prepared by the National Tax Committee of SAICA. This committee consists of sixteen members (including the committee owner

and assistants) representing various large and small audit firms. These commentary documents therefore represent unbiased, balanced commentary.

- The commentary documents contain well-reasoned critique and recommendations on the proposed changes. The inputs received from the various members of the institutions would already have been evaluated and filtered to create concise, focused commentary, as contained in the final commentary document.
- The commentaries are public documents and therefore contain more reliable information than the personal views of selected individuals.

The questionnaires would have represented the personal opinions of a limited number of tax practitioners. It would have also only have been obtained from a single firm – therefore might have represented a biased view not representative of a wider group of tax practitioners.

The research designed will include both the re-analysis of secondary data (the existing legislation), as well as the critical evaluation of primary data (the commentary obtained from SAIT and SAICA). The critical evaluation will also be further extended to identify any possible shortcomings and recommendations which were not specifically included in the commentary documents.

## 3.3. RESEARCH METHODOLOGY

The research was primarily conducted through an extensive literature review of secondary data. South African and international VAT and GST legislation was re-analysed and critically evaluated to understand the methods used to collect VAT and GST on electronically supplied services in the different countries. The outcome of the review was compared to clearly show the differences in the methods currently applied by the different countries in the collection of VAT or GST on electronically supplied services.

The literature review will then be extended in Chapter 4 to include a critical evaluation of the proposed changes to the VAT Act. The primary data sources will be analysed to identify the major shortcomings of the proposals and the recommendations. This critical evaluation of the proposals and analyses of the combined commentary will be used to

firstly evaluate whether the shortcomings in the current legislation are being addressed, and secondly to identify possible additional shortcomings and recommendations which are not evident from the commentary.

Insofar as ethical considerations for the research are concerned, all the documents used in the study (whether primary or secondary sources) are publically available or will be made available by the publishers upon request and therefore no ethical issues arose.

## 3.4. CONCLUSION

This chapter explained that the research will be performed on primary and secondary data sources and will take the form of a qualitative empirical study.

The extensive literature review was conducted in the previous chapter and this literature review will now be extended in the next chapter in order to the critically evaluate the proposals contained in the TLAB.

# CHAPTER 4

# CRITICAL EVALUATION

## 4.1. INTRODUCTION

The literature review in Chapter 2 contrasted current methods used to collect VAT on imported electronically supplied services with the methods used in the EU and New Zealand to emphasize the shortcomings compared to global practices. The proposals contained in the TLAB aimed at addressing these shortcomings were also explained.

Chapter 3 explained that the literature review will be extended in this chapter in order to critically evaluate the proposals contained in the TLAB.

The most important changes brought about by the proposals in the TLAB will now be critically evaluated to determine whether the shortcomings, as identified in the literature review, are addressed. Any potential shortcomings will be identified and recommendations to address these will be made.

## 4.2. CRITICAL EVALUATION

The most important changes brought about by the proposals as outlined in the TLAB are:

- definition of e-commerce services;
- definition of enterprise;
- the requirement for foreign suppliers to register for VAT; and
- the requirement for foreign suppliers to issue a tax invoice.

Each of these changes will be critically evaluated, possible shortcomings identified and suggestions made to address these shortcomings. General comments on the implications resulting from the proposal will also be made.

### 4.2.1. Definition of e-commerce services

#### *4.2.1.1. Critical evaluation and possible shortcomings*

A number of shortcomings are revealed in the critical evaluation of the proposed definition of 'e-commerce services'.

The proposed definition is very wide and will create difficulties when determining which types of services will constitute 'e-commerce services' (Deloitte & Touche VAT Division, 2013:3). It is not clear exactly which services will fall within the scope of the definition. Uncertainty about what exactly is included could lead to non-compliance. The Explanatory Memorandum provides no clear explanation regarding what may be included in services or an explanation that digitised goods will be treated as services (as was done in New Zealand).

Furthermore, the proposed definition in the TLAB states that the '…the placing of an order and delivery of those services is made electronically.' The first problem with this is that 'electronically' has not been defined (South African Institute of Chartered Accountants, 2013:60). It may be argued that this only refers to delivery made through the internet or over a network or in an online environment. It is not clear whether, for example, email and telephonic communication or the use of Bluetooth will be seen as electronic means.

The above two shortcomings can be best explained by the following example:

A South African lawyer (non-vendor) phones a law firm incorporated in Australia to consult on a specific legal matter involving an Australian Company. The Australian law firm compiles a formal consultation document and attaches it to an email in which they respond to the South African lawyer. The South African lawyer pays the Australian Law firm AUD $45.

No goods are delivered to the South African lawyer and therefore the consultation will be a 'service' as defined. However, the placement of the order was made telephonically and the delivery of the service via email communication. It can easily be argued that the placing

and the delivery did not take place electronically. This will mean that the Australian law firm will not have to register for VAT in South Africa seeing that no e-commerce service was supplied. The reverse charge mechanism for collection will once again become applicable placing South Africa in exactly the same position as it was without the proposed changes.

The definition further draws no clear distinction between electronically supplied services and telecommunication services (South African Institute of Tax Practitioners, 2013:1). Both the EU and New Zealand have seen the need to distinguish between the two types of services. The proposals are therefore not aligned with global practices in this respect.

'Electronically supplied services' is a term with which international suppliers are familiar. The introduction and unfamiliarity of a new term (e-commerce services) may hinder already compliant suppliers to register in South Africa seeing that it may be unclear whether or not the services supplied by them falls within this definition.

#### *4.2.1.2. Recommendations*

In order to align the South African VAT Act with global practices definitions for 'electronically supplied services' and 'telecommunication services' should firstly be added to the VAT Act, instead of using 'e-commerce services' and not defining 'telecommunication services'.

A more definite definition should also be provided of exactly what constitutes 'e-commerce services'.

The commentary on the proposals recommended that a list be provided of services which could constitute e-commerce services. There were similarities and differences in the lists recommended but a combination of the lists will include:

- website supply, web-hosting, distance maintenance of programmes and equipment and data warehousing;
- any supply of digitised products which will include software and changes to or upgrades of software;

- supplies of any images, text or information, including making available of databases;
- services providing or supporting a business or personal presence on an electronic network, in response to specific data input by the recipient;
- services automatically generated from a computer through the internet or an electronic network, in response to specific data input by the recipient;
- internet service packages (ISP) of information;
- supply of distance teaching;
- the transfer for consideration of the right to put goods or services up for sale on an internet site operating as an online market on which potential buyers make their bids by an automated procedure on which the parties are notified of a sale by electronic mail automatically generated from a computer;
- the supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events; and
- subscriptions to databases and websites (South African Institute of Chartered Accountants, 2013:59 and South African Institute of Tax Practitioners, 2013:2).

Over and above the recommendations for items to be specifically included in the list of e-commerce services as already specified above, it is recommended that a general item also be added:

- over and above the items specifically listed, any other service delivered over the internet or through a network or via any other delivery method for which minimal human intervention is required.

This additional item will ensure that delivery methods such as Bluetooth or similar means are not excluded.

It is recommended that if a list is used to clarify what falls within the definition of e-commerce services, it should be clearly stated that the list is by no means intended to be an exhaustive list (similar to the EU calling it an ‘Indicative List’). The list should further be reviewed and updated annually in order to keep abreast with new technological

developments (one of the reasons New Zealand is not using a list to define electronically supplied services).

### 4.2.2. Definition of enterprise

#### *4.2.2.1. Critical evaluation and possible shortcomings*

The first problem with this proposal is the proxies being used to determine the place of consumption. An international supplier may not be familiar with the definition of 'resident' as defined in section 1 of Tax Act and therefore if the determination of residency is left to the supplier it will be impractical and arguably unachievable. The possible problem with the second proxy is that it requires that a payment be 'originated' from a South African bank account. If the recipient therefore makes payments from an offshore account, this proxy will not be applicable (South African Institute of Tax Practitioners, 2013:6).

The definition further only includes non-resident suppliers, which creates two problems. The first is that residents could provide similar services from off-shore facilities and this could lead to VAT not having to be declared (South African Institute of Chartered Accountants, 2013:61). The second problem with this is that the EU is moving in the direction that even EU suppliers will as from 1 January 2015 be required to charge the VAT at the consumer's place of consumption. Excluding local suppliers of electronically supplied services from the definition may be regarded as not being aligned with the very principles the proposal is said to be based upon.

The last, and maybe the most important shortcoming of the proposed changes which was not identified in detail by the SAIT or SAICA commentary is that this change will imply that VAT be charged on all supplies of e-commerce services, regardless of whether the supply constitutes a B2C or a B2B supply. The inclusion of B2B supplies (or otherwise not excluding supplies made which will be used in making taxable supplies) will lead to the SARS being in a loss position when this legislation is enforced.

If one uses the same example as in paragraph 4.2.1.1, but assumes that the lawyer is a registered VAT vendor, should he use the consultation provided by the Australian law firm

in making taxable supplies to a South African consumer who is a non-vendor for a consideration of R550 (excluding VAT), the supply falls within the definition of 'e-commerce service' and at an assumed exchange rate of R10, the situation from a VAT perspective will be:

- the Australian law firm will have to register for VAT in South Africa, which will lead to compliance costs for the Australian firm and administration costs for SARS to register the firm as a vendor and process the VAT return which will be furnished;
- the Australian firm will collect R63 (AUD $45 x 14% x R10) VAT and pay it over to SARS; and
- the South African Law firm will pay R63 output tax to the Australian law firm on the import (as explained above) but claim this as an input tax credit against the R77 (R550 x 14%) output tax for the supply made in the RSA – meaning a net payment of R14 (R77 less R63) to SARS.

The administrative cost for SARS to ensure compliance of the Australian Firm will in all likelihood be more than R14, leaving SARS in a net loss position in respect of this transaction.

#### *4.2.2.2. Recommendations*

In the commentary provided by SAIT it was firstly recommended that a self-declaration by the customer combined with reasonable level of identification be used as a proxy to remove the burden of determining residency from the foreign supplier. It was further recommended that the foreign supplier should not be held accountable if false declarations are made by a consumer. This will possibly motivate international suppliers to register in South Africa (South African Institute of Tax Practitioners, 2013:6).

In respect of the second proxy, it is recommended that the word 'originated' be replaced with 'made' or 'effected' to diminish possible ways to avoid the tax (South African Institute of Tax Practitioners, 2013:7).

In the commentary provided by SAICA it was recommended that the proposal is not limited to non-residents (South African Institute of Chartered Accountants, 2013:61). This may be

achieved by re-wording the proposal as follows: "(vi) the supply of e-commerce services by any person [inserted] ~~that is not a resident of the Republic [sic]~~ …"

And lastly, in order to address the last shortcoming, it is recommended that the supply of e-commerce services will only be an enterprise insofar as it will be used by the recipient for making non-taxable supplies. This will be in line with the principles of the EU which only requires VAT to be charged on the supply to non-registered recipients and with New Zealand which only charges GST if used for less than 95% taxable supplies.

This, together with the previous recommendation, will result in the following positive outcomes:

- Less international businesses will be required to register. This will ensure that these suppliers do not withdraw from supplying to South African consumers;
- South African suppliers will also only levy VAT in terms of these rules and the playing field will therefore still be level; and
- SARS will not have to incur great administrative costs to ensure compliance for non-resident suppliers for which the net VAT income are minimal.

### 4.2.3. Registration requirements

#### *4.2.3.1. Critical evaluation and possible shortcomings*

The greatest shortcoming of the registration requirements is that no monetary threshold will be applicable for registration of foreign suppliers of e-commerce services. In the commentary provided by SAICA it was stated that "…the rules applicable to the new category of vendors should neither be more restrictive nor broader ranging than the general governing rules in the VAT Act". If there is no threshold for the registration of foreign suppliers of e-commerce services it will mean that the foreign supplier will not be subject to similar taxation levels and registration requirements as a South African supplier of similar services. This places the foreign supplier in a disadvantaged position and does not promote a neutral tax system (Deloitte & Touche VAT Division, 2013:13).

This inequality may cause foreign suppliers of electronic goods to remove their business from South Africa completely, placing South African consumers in a disadvantaged position.

#### *4.2.3.2. Recommendations*

It is recommended that either a new registration threshold be set for all suppliers of e-commerce services (local and foreign) or that the same thresholds that currently apply for registration of South African suppliers in general also apply to foreign suppliers of e-commerce services.

It is further recommended that the suppliers of e-commerce services be required to submit quarterly VAT returns in order to lighten the administrative burden and streamline compliance. This will be in line with the administration of the EU.

### 4.2.4. Requirement to issue a tax invoice

#### *4.2.4.1. Critical evaluation and possible shortcomings*

The requirement for a foreign supplier to issue the South African consumer with a tax invoice may demotivate international suppliers from registering for VAT (South African Institute of Tax Practitioners, 2013:7). This requirement could even demotivate foreign suppliers from doing business in South Africa since that this places an additional administrative and compliance burden on the supplier.

Foreign suppliers' systems are not necessarily designed to include all the required information of a tax invoice, nor to account for the VAT at 14%. Their systems will therefore have to be re-designed in order to ensure compliance.

#### *4.2.4.2. Recommendations*

It is recommended that the issue of an invoice not be a requirement in order to align the South African law with the rules applied by the HMRC.

### 4.2.5. General comments

In addition to the specific shortcomings in the proposals contained in the TLAB as discussed in this chapter so far, there are some general concerns with the proposed changes.

Firstly, the changes to VAT and GST legislations worldwide, and now also in South Africa, to force suppliers of electronically supplied services to account for the VAT or GST in the country where the service is consumed, is placing immense administrative and compliance burdens on suppliers. For example, a supplier incorporated in Australia who supplies electronic services to consumers in Switzerland, Luxemburg, and South Africa will be required to register for VAT in all three of these countries. In addition to this, the Australian supplier still needs to account for the VAT in the appropriate manner, based on the different VAT legislations and ensure that payments are made on time to avoid penalties and interest. This is an issue that has not at all been considered by the various countries enforcing these new rules.

Another concern is that the success of the proposals will be heavily reliant on, firstly, SARS's ability to enforce compliance and secondly technology being available to assist SARS in achieving the aforementioned. The Explanatory Memorandum is silent on how compliance will be ensured and the means that will be utilised to enforce the proposals. This raises concerns that South Africa, much like New Zealand may, due to the size of the country and the resources available, not be ready to implement changes which require significant investment in technology to enforce compliance.

The Explanatory Memorandum indicated that the reverse charge mechanism will act as the backup for the new place of supply rules. As explained in paragraph 2.2, there are many shortcomings with the reverse charge mechanism and this collection method has proven to be inadequate for the collection of VAT on electronically supplied services. There is however no explanation in the Explanatory Memorandum of how SARS intends to determine when the reverse charge will be applicable, how the consumer will be notified

that the reverse charge applies to the purchase or how SARS intends to ensure compliance.

## 4.3. CONCLUSION

Through the critical evaluation of the proposals (as contained in the TLAB) in this chapter possible shortcomings of these proposals were identified. These possible shortcomings were explained and clarified by the use of a hypothetical example, where applicable. Recommendations to address the possible shortcomings were made.

It is clear from the critical evaluation that there is still work to be done by South African legislators to ensure that proposed changes to the methods to collect VAT on imported services are made in a way that it adequately addresses the shortcomings in the current VAT legislation and is in line with global practices as applicable in a South African environment. The proposed effective date for the proposals, 1 January 2014, may therefore not be a viable and realistic date for the implementation of the proposed legislation.

# CHAPTER 5

# CONCLUSION

## 5.1. INTRODUCTION

The main objective of this study is to critically evaluate the methods as proposed in the TLAB to collect VAT in South Africa on electronically supplied service. The study entailed a detailed literature review of the current provisions in South African and international VAT and GST legislations and summarised the proposed changes to the VAT Act. The research design and methodology were explained, where after the proposals in the TLAB were critically evaluated. The critical evaluation resulted in possible shortcomings to the proposals being identified and recommendations being made to address these shortcomings.

## 5.2. THE LITERATURE REVIEW

The literature reviewed started with the review and critical evaluation of sections 7(1)(c) and 14 of the VAT Act, read with the definition of 'imported services'. This review showed that electronically supplied services currently fall within the scope of the definition of 'imported services' and will therefore be taxed based on the reverse charge mechanism contained.

Through the use of an example it was shown that there are many shortcomings in respect of this method to collect VAT on imported services.

The first shortcoming identified was that the current method relies heavily upon the honesty of the recipient and the recipient being aware of the obligation to declare and pay the VAT on the electronic service purchased from a foreign supplier. Consumers are however often ignorant regarding the obligation that the legislation places on them.

The second was that the cost to effectively police the current legislation may exceed the benefit for the fiscus, due to the difficulty to identify participants in transactions in online environments.

The fact that the current method is paper-based, making the declaration and payment inconvenient for the recipient, was also identified as a shortcoming of the current legislation. The fact that a recipient needs to declare and pay the VAT at a SARS branch makes it less likely that the declarations and payments will ever be made by recipients on imported electronically supplied services.

The last shortcoming was that the current threshold of R100 per transaction may lead to consumers structuring transactions in such a way to fall below R100 in order to be exempt from the declaration and payment of the VAT.

These shortcomings proved that the current method to collect VAT on electronically supplied services falls short in many ways and is becoming increasingly inefficient due to the growing internet economy and smartphone explosion in South Africa.

The literature review continued to review the legislation enacted in the EU and New Zealand regulating the methods used to collect VAT and GST on electronically supplied services. This review showed both the EU and New Zealand attempted to define ‘electronically supplied services’ and differentiate these services from ‘telecommunication services’. In the EU foreign suppliers are required to register for VAT and pay the VAT over to the member state in which it is registered. In New Zealand registered recipients, applying a threshold of NZ $ 60 000 for registration, are responsible for the declaration and the payment of the GST. It further highlighted that although the administration of the systems differs, specific sets of rules, under which the VAT and GST on the supply of these services are collected, is in place in both countries.

The last part of the literature review provided an overview of the proposed changes to the VAT Act as contained in the TLAB. The major elements of the changes were the definition of e-commerce services, the addition to the definition of an enterprise deeming non-resident suppliers of e-commerce services to be carrying on an enterprise in South Africa,

the fact that no monetary registration threshold will apply to these suppliers and lastly that these suppliers will still be required to issue South African recipients with a tax invoice.

These changes were contrasted against current legislation by the use of an example. The example also showed the impact of the proposals on the foreign suppliers of electronically supplied services and on the consumers.

## 5.3. THE CRITICAL EVALUATION

The critical evaluation of the proposals as contained in the TLAB highlighted, in some cases by the use of examples, the possible shortcomings of the proposals. Recommendations to address these shortcomings were made and explained.

The main shortcomings and the recommendations made to address the shortcoming can be is summarised in the table below.

**Table 3: Summary of shortcomings and recommendations**

| | Shortcoming | Recommendation |
|---|---|---|
| 1 | Using e-commerce services as definition for electronically supplied services – a term not known to foreign suppliers | Change the definition to 'electronically supplied services' |
| 2 | No definition for telecommunication services to differentiate from electronically supplied services | Add a definition for telecommunication services |
| 3 | E-commerce services are very widely defined | Use of an illustrative list of possible e-commerce services to provide a more definite definition |
| 4 | In terms of the first proxy in the definition of 'enterprise', the determination of residency of the recipient is left to the foreign supplier | Use a self-declaration by the customer and reasonable level of identification as proxy |

| | Shortcoming | Recommendation |
|---|---|---|
| 5 | The word 'originated' as used in the second proxy in the definition of 'enterprise' | Replace 'originated: with 'made' or 'effected' |
| 6 | The definition of enterprise only includes non-resident suppliers | Changing the definition to include any person, not only non-resident suppliers |
| 7 | B2B supplies are included, i.e. even if the supply will be used in making taxable supplies | VAT should only be charged insofar the recipient will use it for a purpose other than making taxable supplies |
| 8 | No monetary registration threshold for foreign suppliers | A threshold (even if it is very low) should be set |
| 9 | Requirement to issue a tax invoice to recipients | The issue of a tax invoice should not be a requirement |

The critical evaluation also highlighted that the compliance burden on suppliers worldwide is becoming immense due to many countries requiring non-resident suppliers of electronically supplied services to register for VAT or GST. This may lead to suppliers withdrawing from countries forcing registration.

Chapter 4 concluded that South Africa may not yet be ready to implement the proposed changes on 1 January 2014, and that some very needed changes to the proposals should first be made in order to adequately address the shortcomings in the current legislation and to align South African legislation with global practices.

## 5.4. SUGGESTIONS FOR FURTHER RESEARCH

This study was limited to the methods applied to collect VAT on the electronically supplied services in B2C transactions. The methods to collect VAT and GST on telecommunication services were not addressed. B2B transactions, including the special rules for intercompany and interdivisional transactions, were also not addressed. These may be areas that could be considered for further research.

This study was conducted before the proposals in the TLAB were enacted. A follow-up study could be conducted to critically evaluate any changes to the proposals.

The financial impact on the fiscus due to non-compliance as well as the administrative burden placed on suppliers of e-commerce services by new legislation worldwide were also not quantified as part of this research study. Both of these could be further researched in order to quantify the impact of e-commerce and the explosion in the use of smartphones on the tax base as well as on foreign suppliers.

## 5.5. CONCLUSION

This study found that, due to the explosion of the smartphone market in South Africa, the internet economy is rapidly growing and more and more South Africans are purchasing electronically supplied services. The current methods for the collection of the VAT on electronically supplied services became almost impossible to police.

It was therefore concluded that National Treasury and SARS correctly identified that changes should be made to the VAT Act in order to address the current shortcoming in order to prevent the erosion of the tax base.

The critical evaluation indicated that there are a number of shortcomings in the proposed changes to the VAT Act. SARS and National Treasury should consider the recommendations before the proposals are enacted to ensure that the changes appropriately address the shortcomings in the current legislation, aligns the South African VAT Act with global practices in a South African environment and do not result in more shortcomings which could lead to tax evasion.

The study further highlighted to foreign suppliers of electronic services to South African recipients that cognisance should be taken of the new requirements which will be applicable as from 1 January 2014 as proposed. Non-compliance could lead to penalties and interest.

Lastly, consumers who regularly purchase music, e-books, games, applications and so forth from suppliers who are not South African residents, for example iStore, should be aware that the prices of these product will most likely go up as from 1 January 2014 when foreign suppliers levy VAT at 14 per cent to the cost.

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