Transfer Pricing and Tax Avoidance: Is the Arm’s-length Principle Still Relevant in the e-Commerce Era?

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1 Introduction

The arm’s-length principle is internationally used as a means of curbing tax avoidance through transfer pricing. However, when trade is conducted electronically, the application of this principle faces major challenges. The purpose of this paper is to analyse our law so as to determine whether this principle is still relevant in curbing transfer principle in the e-commerce era.

The article will begin by explaining the meaning of certain concepts. Then an explanation will be offered of what the arm’s-length principle entails and how it has been challenged by e-commerce. The article will also point out international views about transfer pricing and e-commerce. Finally, recommendations will be made after considering the relevance of South Africa’s Electronic Communications and Transactions Act 25 of 2002.

2 Background Information and Definition of Concepts

Tax avoidance refers to the use of perfectly legal methods of arranging one’s affairs so as to pay less tax.1 This is contrasted with tax evasion which is illegal and usually involves the non-disclosure of income, the rendering of false returns, and the claiming of unwarranted deductions. Tax avoidance involves utilising loopholes in tax laws and exploiting them within legal parameters.2 In this regard, the courts have held the view that no legal obligation rests upon a taxpayer to pay a greater amount of tax than is legally due under the applicable taxing legislation.3 For instance, in the celebrated case of Duke of Westminster v IRC,4 Lord Tomlin held that ‘every man is entitled if he can to order his

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3 Levene v IRC [1928] AC 217 (HL) at 227; Ayrshire Pullman Motor Services & DM Ritchie v IRC (1929) 14 TC 754; Hicklin v SIR 1980 (1) SA 481 (A); CIR v Estate Kohler & Others 1953 (2) SA 584 (A) at 591F-592H; CIR v Sunnyside Centre (Pty) Ltd 1997(1) SA 68 (A) at 77F.
4 [1936] AC 1 (HL) at19-20.

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138
One of the mechanisms employed by taxpayers to avoid taxes is transfer pricing. The term ‘transfer pricing’ describes the process by which related entities set prices at which they transfer goods or services between one another.\(^5\) Transfer pricing is also described as the systematic manipulation of prices in order to reduce or increase profits artificially or to cause losses and avoid taxes in a specific country.\(^6\) A transfer price is a price set by a taxpayer when selling to, buying from, or sharing resources with a related or connected person. It is usually contrasted with a market price, which is the price set in the marketplace for the transfer of goods and services between unrelated persons\(^7\) where each party strives to get the utmost possible benefit from the transaction.\(^8\) Transfer prices are usually not negotiated in a free, open market and so they may deviate from prices agreed upon by non-related trading partners in comparable transactions under the same circumstances.\(^9\)

Transfer pricing between subsidiaries of one enterprise which are all resident in one country usually poses minimum tax-avoidance problems since the relevant national law is the same for all the subsidiaries in the group. Transfer pricing is most problematic when it comes to multinational corporations trading in various jurisdictions.\(^10\) A multinational corporation is usually composed of a number of legally autonomous but interrelated companies or subsidiaries operating in different countries but being directed by a single parent company.\(^11\) Since the related companies operate in different countries, they are not subject

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\(^7\) Arnold & McIntyre op cit note 5 at 55.


\(^10\) Report of the OECD Committee on Fiscal Affairs ‘Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrators’ (1994) 172 Intertax at 318 in par 12; Vito Tanzi, writing in International Monetary Fund Working Paper Globalization, Tax Competition and the Future of Tax Systems (1996) at 6, notes that statistics show that a significant and growing part of current world trade is among different parts of the same multinational enterprise which have the different aspects of their production process in different countries. For instance raw materials are obtained in one country, converted into intermediate products in another, and finished in yet another country.

\(^11\) Sylvian RF Plasschaert Transfer Pricing and Multinational Corporations: An Overview of Concepts, Mechanisms and Regulations (1979) at 3-4. See also SARS Practice Note No 7 op cit note 5 in par 1.2.3 which defines a multinational as any group of connected persons with members or business activities in more than one country.
to the same laws and regulations, especially in tax matters. Related companies in a multinational group may thus resort to fictitious transfer pricing in order to manipulate profits so that they appear lower in a country with higher tax rates but higher in a country with lower tax rates. For example, if the member of a multinational sells goods to a connected person resident in one country at a reduced price, the profit the multinational earns in that country will be increased. High profits may also be achieved if an entity in a low-tax jurisdiction charges a related foreign company in a higher-tax jurisdiction artificially high fees for products such as technical know-how, patents, leasing and other managerial, administrative and operational services. These fees could also be charged to an affiliate for activities which have in fact not been provided at all. If a low or high consideration (non-market value) is paid for the transfer of products and services between the members of a multinational, the income calculated for each of those members will be inconsistent with their relative economic contributions. This distortion will have an impact on the tax revenues of the relevant jurisdictions in which the multinational operates.

Multinationals are able to manipulate transfer prices due to the network of internal payments that result from the goods they supply to each other. Between the various channels through which payments occur within the multinational, some degree of substitution of costs often occurs that allow the members of the group the freedom to establish conditions in their intra-group trade which are not available in uncontrolled trade between unaffiliated companies. When independent enterprises deal with each other, the conditions of their commercial and financial relations are generally determined by market forces of supply and demand. But if one enterprise owns the capital of the other, it may be able to exercise a significant influence over the activities of the other and both may be able to benefit from the sharing of knowledge and resources. In that way, prices set for the international trade between the group members may deviate from the ‘normal’ or arm’s-length prices. The tax savings obtained through transfer pricing appear to be a major incentive to the setting up of subsidiaries in tax-haven jurisdictions. These subsidiaries are used to maximize profits and reduce the global tax exposure of the group.

The role that multinational companies play in world trade has increased dramatically over the last 20 years. It has been estimated that about 50 per cent

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12 Plasschaert op cit note 11 at 1; Arnold & McIntyre op cit note 6 at 54; Jon E Bischel & Robert Feinschreiber *Fundamentals of International Taxation* 2 ed (1985) at 27.
13 Plasschaert op cit note 11 at 1; Stroud & Masters op cit note 6 at 10; United Nations op cit note 2 at 26; Rotterdam Institute for Fiscal Studies op cit note 2 at 45; Anthony Ginsberg *International Tax Havens* 2 ed (1997) at 20; Tanzi op cit note 10 at 7.
14 SARS *Practice Note No 7* op cit note 5 in par 2.2-2.3; see also United Nations op cit note 2 at 26; Annamaria Rappako *Base Company Taxation* (1989) at 16.
15 United Nations op cit note 2 at 27.
16 SARS *Practice Note No 7* op cit note 5 in par 2.2.
17 Plasschaert op cit note 11 at 4; Richard A Westin *International Taxation of Electronic Commerce* (2000) at 185 notes that a multinational enterprise may have a strong incentive to shift income deductions or tax credits among commonly controlled entities in order to arrive at a reduced overall tax burden.
18 Hay et al op cit note 8 in par 32.
19 OECD Report op cit note 10 at 316; Hay et al op cit note 8 at 423 where it is noted that multinational enterprises now account for 60 per cent of world trade and that the top 100 multinational enterprises own 20 per cent of world assets.
of world trade is carried on between related companies and it is expected that
cross-border trade between related companies will increase both in absolute
terms and as a percentage of world trade.\(^20\) This trend may be attributed to
increased globalization. Multinationals have actually been referred to as the
‘big players’ in international trade, that drive the globalization process froward,
and that are accompanied by an increasing number of medium-sized companies
participating in cross-border joint ventures. Another factor contributing to the
growth of multinationals is the development in telecommunications which
allows businesses to access world markets easily and cheaply without being
limited by geographical boundaries of their countries. Of major concern in this
regard has been the development of what has come to be known as electronic
commerce (‘e-commerce’).

Most developed countries that impose income taxes at significant rates are
concerned about the loss of tax revenue resulting from transfer pricing and
they have therefore passed some kind of transfer-pricing provisions in their tax
laws. The objective of this paper is to discuss the challenges that conducting
trade electronically poses to South Africa’s transfer-pricing provisions and
how this opens up opportunities for tax avoidance.

3 South African Transfer-pricing Provisions

There has been an increase in international trade and commerce ever since
South Africa’s re-entry into international commerce. Much of this trade is
carried on between members of multinational groups of companies.\(^21\) With
the increase in international trade and the resultant globalization of business
activities, the protection of the South African tax base from multinational
transfer-pricing schemes is of the utmost importance.

The provision that is used to curb tax avoidance through transfer pricing was
first introduced in the South African Income Tax Act in 1995.\(^22\) The provision
was set out in s 31 of the Act. The measure was introduced as a result of
recommendations of the Katz Commission in 1994.\(^23\) However, the original
provisions under s 31 were limited to the purchase and sale of commodities in
circumstances where one of the two related enterprises was a foreign enterprise
resident in a country with which South Africa had concluded a double-taxation
treaty.\(^24\) The rules aimed at giving effect to the right conferred to South
Africa as a contracting state to determine the taxable income of a taxpayer
as if the commodity had been bought or sold at an arm’s-length price which
was determined according to the provisions of the particular double-taxation
agreement.\(^25\) Exchange control measures, and to a certain extent customs

Documentation 535.
\(^21\) SARS Practice Note No 7 op cit note 5 in par 2.4.
\(^22\) Idem in par 4.1.
\(^23\) See the Interim Report of the Commission of Inquiry into the Tax Structure of South Africa (1994)
in par 1.
\(^24\) Lynette Olivier, Emil Brincker & Michael Honiball International Tax: A South African Perspective
\(^25\) De Koker op cit note 1 in par 17.54.
duties, were also used to resolve transfer-pricing problems. However, the high tax rates on income earned by foreign investors in South Africa, as well as the exchange control restrictions that applied in regard to the repatriation of profits and capital, led to a substantial manipulation of prices by non-resident investors. To counter this state of affairs, that had also escalated with the continuing relaxation of exchange controls, there was a need for a complete revision of s 31.

The revised s 31 now contains detailed anti-avoidance measures aimed at preventing the artificial removal of what would otherwise be South African taxable profit into another jurisdiction either by overstating certain deductions allowable in the determination of taxable income, or by understating the amount which is received by or accrues to an entity. Section 31(2) provides that

‘where any goods or services are supplied or acquired in terms of an international agreement and the acquirer is a connected person in relation to the supplier; whereby goods or services are supplied or acquired at a price which is either less than the price which such goods or services might have been expected to fetch if the parties to the transactions had been independent persons dealing at arm’s length (such price being the arm’s length price); or greater than the arm’s length price, then for purposes of this act in relation to either the acquirer or supplier, the commissioner may, in the determination of the taxable income of either the acquirer or supplier, adjust the consideration in respect of the transaction to reflect an arm’s length price for the goods or services’.

In brief, the section provides that the Commissioner may adjust the consideration for goods or services supplied in terms of an international agreement if the actual price paid is either less or more than the price that would have been paid had the goods or services been supplied or rendered between independent parties dealing on an arm’s-length basis. In other words, the adjustment is based on the conditions which would have existed between unconnected persons under comparable circumstances.

The arm’s-length principle as enshrined in s 31(2) is internationally accepted and is used by countries both members and non-members of the OECD. Paragraph 1 of art 9 of the OECD Model Tax Convention on Income and on Capital provides that when conditions are made or imposed between two associated enterprises in their commercial or financial relations which differ from those which would have been made or imposed between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and be taxed accordingly. The reason why the arm’s-length principle has been adopted...
internationally is that it places multinational companies and independent enterprises on an equal footing for tax purposes, so eliminating any economic distortions that differential tax treatment may create. By removing such distortions, the arm’s-length principle promotes the growth of international trade and investment.

4 Determining an Arm’s-length Price

The Commissioner of SARS determines an arm’s-length price by using one of the methods set out in Practice Note No 7.32 Although SARS Practice Notes or Interpretation Notes are not law,33 Practice Note No 7 sets out the methods which have been developed in international practice for determining and appraising a taxpayer’s transfer prices. These methods are recognised by the OECD Guidelines.34 Although South Africa is not a member country of the OECD, the Guidelines remain important as they have become a globally accepted standard.35 Following them will be instrumental in assisting South Africa in curbing tax avoidance. In a 1998 OECD Report36 it was pointed out that the failure to adhere to international transfer-pricing principles was a contributing factor to the increase of harmful preferential tax regimes. Following the OECD Guidelines will thus aid South Africa in promoting tax equality and will reduce the possibility of South Africa contributing to the establishment of such a tax regime.37

The transfer-pricing methods recommended by the OECD and also employed in South Africa fall under two categorises; the traditional transactional methods and the profit-based methods.38 Under the first category fall methods such as the comparable uncontrolled-price method, the resale-price method, and the cost-plus method. Under the second category fall the transactional net-margin method and the profit-split method.

The comparable uncontrolled-price method is the primary pricing method. It requires a direct comparison to be drawn between the price charged for a specific product in a controlled transaction and the price charged for a closely comparable product in an uncontrolled transaction in comparable circumstances.39 The comparable uncontrolled-price method is the most

31 OECD ‘Transfer Pricing Guidelines’ op cit note 10 at 324 in par 24; see also Miesel et al op cit note 8 at 2.
32 SARS Practice Note No 7 op cit note 5 in par 9.1.2-9.1.3. See also De Koker op cit note 1 at 17.59.
33 See ITC 167, 62 SATC 219.
35 SARS Practice Note No 7 op cit note 5 in par 3.2.1. See also Francis M Horner ‘International Cooperation and Understanding; What’s New about the OECD’s Transfer Pricing Guidelines’ (1996) 50 University of Miami LR 577.
37 SARS Practice Note No 7 op cit note 5 in par 3.2.2.
38 OECD ‘Transfer Pricing Guidelines’ op cit note 10 at 336 in par 87. See also Bischel & Feinschreiber op cit note 12 at 231.
preferred method because it is the most direct and reliable way to apply the arm’s-length principle.\(^{40}\)

Where there are no comparable sales, the resale-price method is employed. This method is based on the price at which a product which has been purchased from a connected enterprise, is resold to an independent enterprise. The resale price is then reduced by an appropriate gross margin, to cover the reseller’s operating costs, so as to provide an appropriate profit, having taken into consideration the functions performed, assets used and risks assumed by the reseller. The balance is then regarded as the arm’s-length price.\(^{41}\) This method in effect works back from the sales price of the product to unrelated parties outside the group and determines an appropriate mark-up percentage for the sales between related parties. The resale-price method is most appropriate where the reseller does not add significant value to the product.

The cost-plus method requires an estimation of an arm’s-length consideration by adding an appropriate mark-up to the costs incurred by the supplier of goods or services in a controlled transaction. This mark-up should provide for an appropriate profit to the supplier, in the light of the functions performed, assets used and risks assumed.\(^{42}\) This method is most suitable when services are provided or where semi-finished goods are sold between connected parties and where they have concluded long-term buy and supply arrangements. The mark-up is determined with reference to the mark-up earned by a similar independent supplier in an uncontrolled transaction bearing similar risks and employing similar assets to those of the taxpayer.\(^{43}\)

In general a flexible approach is used when applying the above transaction-based methods. Where there are any differences between the controlled and the uncontrolled transactions that have a material effect on the final price, such differences may be accounted for through reasonable adjustments.\(^{44}\) However, even with such flexibility there are cases where the degree of comparability is not satisfactory.

In response to the constraints of these transaction-based methods, the OECD has developed other methods – which are also applied in South Africa – that are less adversely affected. These methods are referred to as profit-based methods. It is argued that profit-based methods are not unduly influenced by the characteristics of a particular transaction such as the functions performed, assets used and risks assumed.\(^{45}\) Examples are the transactional net-margin method and the profit-split method.

The transactional net-margin method examines the net profit margin that a taxpayer realises from a controlled transaction, relative to an appropriate base

\(^{40}\) Hay et al op cit note 8 at 432 in par 64.
\(^{41}\) SARS Practice Note No 7 op cit note 5 in par 9.5.1. See also OECD ‘Transfer Pricing Guidelines’ op cit note 10 at 338 in par 65; Campos op cit note 39 at 217; Hay et al op cit note 8 at 432 in par 66.
\(^{42}\) SARS Practice Note No 7 op cit note 5 in par 9.6.1. See also OECD ‘Transfer Pricing Guidelines’ op cit note 10 at 342 in par 115; Campos op cit note 39 at 217.
\(^{43}\) SARS Practice Note No 7 op cit note 5 in par 9.6.2.
\(^{44}\) Hay et al op cit note 8 at 433 in par 71.
\(^{45}\) Ibid.
of, for example, costs, sales or assets. The profit-level indicator of the tested party is compared to the profit-level indicators of comparable independent parties.\textsuperscript{46}

Under the profit-split method, the combined profit is identified and split between the connected parties in a controlled transaction. The profit is split by economically approximating the division of profits that would have been anticipated and reflected in an agreement made at arm’s length.\textsuperscript{47} The profit-split method is usually applied where transactions are so interrelated that they cannot be evaluated separately.\textsuperscript{48}

Generally, all the above methods are based on measuring a multinational’s pricing strategies against a benchmark of the pricing strategies of independent entities in uncontrolled transactions.\textsuperscript{49} The Commissioner of SARS uses the most appropriate of these methods, depending on the particular situation and the extent of reliable data. The suitability and reliability of a method thus depends on the facts and circumstances of each business and the market realities applicable to each individual case.\textsuperscript{50} However, as a general rule the traditional-transaction methods are preferred. The Commissioner recommends the use of a four-step approach developed by the Australian Tax Office in order to arrive at an arm’s-length price.\textsuperscript{51} This approach requires that, firstly, there is a need to understand the cross-border dealings between connected persons in the context of the taxpayer’s business; secondly an appropriate transfer-pricing method must be selected; thirdly, that the transfer-pricing method has to be applied; and finally, that an arm’s-length price must be calculated in accordance with the selected method.

Although on the whole the arm’s-length principle has been found to work effectively in the vast majority of cases, especially those involving the purchase and sale of commodities undertaken by comparable independent enterprises, there are a number of significant cases in which the principle is difficult and complicated to apply.

5 The Problems of Arriving at an Arm’s-length Price in the e-Commerce Era

The application of the arm’s-length principle is even more difficult when trade is conducted electronically.\textsuperscript{52} The impact of e-commerce on transfer pricing received attention at the OECD Ottawa Conference on e-commerce in 1998 in a discussion document prepared by the Fiscal Affairs Committee for the conference.\textsuperscript{53} It was noted that e-commerce has presented neither fundamentally
new nor categorical different problems for transfer pricing. However, it has the potential to make the resolution of some of the problems of transfer pricing more difficult. This is because e-commerce has the effect of removing physical boundaries, making it significantly more difficult for tax administrators to identify, trace, quantify and verify cross-border transactions.54

As the purpose of this article is to point out some of the challenges of applying the arm’s length principle in the e-commerce era, it is important to consider how e-commerce affects the meaning of certain words or phrases as used in s 31(2) of the Income Tax Act.

5.1 The Effect of e-Commerce on the Meaning of ‘goods’ and ‘services’

In terms of s 31(2) there must be ‘goods or services’ that are supplied or acquired. The term ‘goods’ as used in s 31(1) includes any corporeal movable thing, fixed property and any real right in any such thing or fixed property. The term ‘services’ is defined as including anything done or to be done, including the granting, assignment, cession or surrender of any right, benefit or privilege, the making available of any facility or advantage, the granting of financial assistance including a loan advance or debt and the provisions of any security or guarantee, the performance of any work, an agreement of insurance or the conferring of rights to incorporeal property.55

In traditional commerce, differences in the characteristics of goods or services offered usually determine their value in the open market. In the case of tangible goods, the characteristics that can be compared include the physical features of the goods, their quality and reliability, and also the availability and volume of supply. In the case of the provision of services, comparable characteristics could include the nature and extent of the services. And in the case of intangible property such as patents and copy rights, characteristics that could be compared are the duration and degree of the protection of the property rights.56 The characteristics of goods or services that are offered electronically are quite different from those in traditional commerce. This is because the very character of the goods or services is altered as a result of the de-materialisation created by e-commerce.

In the case of goods, products that were previously supplied in physical form, can now be supplied in digital form. Examples of goods that can be supplied in this way include digital music, films and package software.57 Digitisation affects comparability in that the durability of the product – as a factor that can be used to compare the price of goods – is affected. Music on a video or a compact disk can be used many times, but if the music is digitised, the availability of that music is subject to management by the supplier. In addition,
the fact that digitised products may be copied whether legally or illegally affects its value. In such instances, it becomes futile to find comparable prices for digital goods.

Likewise, services may also be offered electronically. However, the character of electronically offered services differs from that of services offered physically. For instance, services offered physically by a consultant may be accessed electronically from a database, on-line-consulting can be effected either through video conferencing or electronic messaging. The services of a physical consultant are usually very expensive, unlike that for electronically offered services. As a result, a multinational located in a high-tax country may be provided with a number of non-physical services at minimum cost from remote locations rather than having to pay high fees and taxes if those services are offered physically and locally. Services could, for instance, be accessed from help pages on the Internet that provide administrative services such as planning, coordinating, financial advice, accounting, auditing, legal, factoring, computer and financial services. Typically such services are dealt with under cost-plus arrangements and cost-sharing arrangements. Where cost-plus is appropriate for services of this kind, and the activities are shifted to low-cost jurisdictions, the profit allocation will be reduced proportionately. With the development of enterprise resource planning software, it is also possible for all stages of a commercial transaction, from order placement through to billing and payment, to be completed on-line. This is usually at a fraction of the cost of more traditional methods of transacting business. Commenting on this issue, the OECD Report on the Economic and Social Impact of Electronic Commerce estimates that e-commerce results in distribution costs being cut by about 5 per cent.

5.2 The Effect of e-Commerce on the Meaning of the Term ‘international agreement’

Section 31(2) requires that in order to apply the arm’s-length principle, there must be an ‘international agreement’ in terms of which the goods or services are supplied. The term ‘international agreement’ is defined in s 31(1) as a transaction, operation or scheme entered into between a resident and a non-resident, or an agreement between two non-residents for the supply of goods or services to or from a permanent establishment of either of them in South Africa. The term ‘international agreement’ also refers to an agreement between two South African residents for the supply of goods or services to or from a ‘permanent establishment’ of either of such persons outside the country. I will first consider how the verification of the existence of an international transaction can be achieved.

59 Schwartz op cit note 54 at 289.
60 Ibid.
61 De Koker op cit note 1 in par 17.55. See also Van Blerck op cit note 9 at 45; Olivier et al op cit note 24 at 193.
agreement is itself affected by e-commerce, and then how the meaning of the term ‘permanent establishment’ is affected by e-commerce, thus making it difficult to apply the arm’s-length principle.

5.2.1 The Effect of e-Commerce on Verifying the Existence of an ‘international agreement’

Documentary proof is required to determine whether an international agreement exists. SARS has indicated\(^62\) that some of the documents that will be required of taxpayers include: the transfer pricing policy document which should contain issues like; the identification of the relevant transactions in terms of international agreements with the connected persons; copies of international agreements entered into with connected parties; a description of the nature and terms of the relevant transaction and also the price; the methods used to arrive at the nature and terms of the relevant transactions; an explanation of the process used to select and apply the method used to establish the transfer prices; information relied on in arriving at the arm’s-length terms, such as agreements with third parties, financial information, budgets and forecasts; and any other details or circumstances that have influenced the prices that have been set.\(^63\)

In traditional commerce, it is not difficult to get a copy of an international agreement that was entered into by the concerned parties. Details about such an agreement can also be found in a taxpayer’s financial records which normally indicate the taxpayer’s name, address and even the value of financial transactions engaged in. These records are normally reliable and cannot easily be altered without detection. Sometimes, however, relevant information may not be easily accessible, or it may be difficult to interpret. Some information may not even be easily obtainable because of confidentiality concerns or geographical reasons, or it may simply not exist.\(^64\) In the e-commerce era, these matters become even more complicated and it may be difficult to procure an international agreement as there is usually no paper trail of e-commerce transactions. The available information may further not be reliable as it can be altered easily and undetectably to avoid taxes. e-Commerce also makes it easy to split the various risks and activities in a multitude of ways that may make it hard to obtain relevant data. As a result, the information available may not meet the standard of comparability that may be required in order to arrive at an arm’s-length price.\(^65\)

Commenting on the issue of documentation, at the OECD Ottawa Conference on e-commerce in 1998, it was indicated that although the transaction-based methods are preferred in arriving at an arm’s-length price, they cannot be relied on in the e-commerce era because of the insufficiency

\(^62\) In par 10.3 of Practice Note No 7 op cit note 5, read in conjunction with IT 14 Corporate Income Tax Return (2001) and the SARS accompanying brochure, IT 14B.

\(^63\) See also Olivier et al op cit note 24 at 206.

\(^64\) OECD ‘Transfer Pricing Guidelines’ op cit note 10 at 325 in par 28-9.

of data on uncontrolled transactions, the lack of reliable data, or the highly integrated nature of the business operation. The OECD is of the view that in these situations the transaction-profit methods, such as the profit-split method, should be employed.66

5.2.2 The Challenges of Applying the Arm’s-length Principle to the ‘permanent establishment’ Concept in the e-Commerce Era

As noted earlier, the term ‘international agreement’ also refers to an agreement between a taxpayer and its ‘permanent establishment’.67

For South African income-tax purposes, the term ‘permanent establishment’ is defined in s 1 of Income Tax Act as a permanent establishment as defined from time to time in art 5 of the OECD Model Tax Convention on Income and on Capital. This article refers to a ‘permanent establishment’ as a fixed place of business through which the business of an enterprise is wholly or partly carried on. This includes a place of management, a branch, or an office or a factory.68 However, it excludes the maintenance of a fixed place of business solely for the purpose of carrying on any activity of a preparatory or auxiliary character on behalf of the enterprise. Article 5(5) also provides that a dependent agent acting on behalf of a parent company in another state is also to be treated as permanent establishment. However, the activities of the dependent agent should not be of a preparatory or auxiliary nature.

Double-taxation agreements that follow the OECD Guidelines (as is the case with South African ones) provide that allocations between a permanent establishment (branch) and its parent company must be at arm’s length as if the branch and its head office are independent parties, despite the branch not being a legal person separate from its head office.69 In terms of s 108 of the Income Tax Act read with s 232 of the Constitution of the Republic of South Africa, 1996, when a double-taxation agreement is concluded, it becomes part of the law of the land.70 An example of a South African tax treaty in which this principle is applied is the treaty with the United Kingdom.71

67 De Koker op cit note 1 in par 17.55. See also Van Blerck op cit note 9 at 45; Olivier et al op cit note 24 at 193.
68 The term ‘permanent establishment’ as defined in art 5 also includes a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources. It also includes a building site or construction or installation project which lasts for more than twelve months.
69 If a parent company sets up a branch (other than a subsidiary) in another country, that country can in principle not tax the profits from the branch, as a branch is not considered a separate legal entity. However, if a double-taxation treaty applies between the two countries that is based on the OECD Model Tax Convention, its art 5 provides that the branch is treated as a permanent establishment of the parent company in the other country. The OECD Model Tax Convention operates on the principle that profits arising from a business enterprise are taxed in the state where it is resident (see the residence tie-breaker rules in art 4(2)(a) of the Model Tax Convention). However, if the enterprise carries on business in the other contracting state through a permanent establishment, the profits of the enterprise that are attributable to the permanent establishment will, in terms of art 7, be taxable in the other state. See also Reinhardt Buys & Francis Cronje Cyber Law: The Law of the Internet in South Africa 2 ed (2004) at 239; Lilian Edwards & Charlotte Waelde Law and the Internet: Regulating Cyberspace (1997) at 171; Arnold & McIntyre op cit note 6 at 118.
70 Olivier et al op cit note 24 at 191.
71 See Government Gazette 24335 of 31 Jan 2003 where the Treaty has been published.
5.2.2.1 Physical Presence Permanent Establishments

The definition of a ‘permanent establishment’ shows that there must be either a physical presence in the state concerned or there must be a dependent agent.

In regard to physical presence permanent establishments, the meaning of the term permanent establishment presupposes that there must be a ‘fixed place of business’ through which the business of the enterprise is ‘carried on’. The term ‘place of business’ covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and where it simply has a certain amount of space at its disposal.72 The 2003 Commentary to the OECD Model Tax Convention states that the place of business has to be a ‘fixed’ one in that ‘there has to be a link between the place of business and a specific geographical point’. However, it does not mean that the equipment constituting the place of business has actually to be fixed to the soil on which it stands.73 The business of the enterprise has to be ‘carried on through’ the establishment. This implies that the activities carried on at the establishment must be business related.74 The phrase ‘carried on through’ further implies that the business activities must be carried on wholly or partly through the particular location that is at the disposal of the enterprise for that purpose.75 In other words, the establishment cannot itself be the business (for instance by itself being traded, rented or produced), but it must facilitate the carrying out of the business.76

In the e-commerce era, it is difficult to determine whether a permanent establishment actually exists so as to ensure that allocations between a permanent establishment and its parent company are at arm’s length. If a customer makes purchases by logging onto a website on a computer located in South Africa, can that website be considered a permanent establishment of the business enterprise? In answering this question, one has, first, to resolve the issue as to whether a website or a server is a fixed place of business. Secondly, it has to be determined whether the activities carried out through the website or the server constitutes the carrying on of business activities which would result in a permanent establishment.

In order to determine whether a website or server is a fixed place of business, it is necessary to draw a distinction between a website and a server.

An Internet website is the software and electronic data that is stored on the server. The website is what appears on the computer screen and allows an

72 Paragraph 4 of the Commentary on art 5 of the OECD Model Tax Convention op cit note 8; see also Olivier et al op cit note 24 at 323.
73 Paragraph 5 of the Commentary on art 5 of the OECD Model Tax Convention op cit note 8; see also Olivier et al op cit note 24 at 323.
75 Paragraph 4.6 of the Commentary on art 5 of the OECD Model Tax Convention op cit note 8.
76 Doernberg et al op cit note 74 at 206.
enterprise to interact with its customers. However, it is not like a ‘brick and motor office’ and so it has been referred to as a ‘virtual office’. The question, therefore, is whether such a virtual office constitutes a fixed place of business that has a ‘physical presence’ in a country as is required by the meaning of the term ‘permanent establishment’. A website is intangible property; it is not physical and therefore cannot be deemed to be a fixed place of business for purposes of the term in question.

By contrast, a server is the automated equipment on which an Internet website is stored and through which the website is accessed. Since a server is a piece of equipment, it can have a physical location. Such a physical location may constitute a ‘fixed place of business’ and therefore a permanent establishment of the enterprise that operates that server. Often the website through which the enterprise carries on its business, may be hosted on the server of an Internet service provider. Such hosting is usually arranged by providing an amount of disk space for the website for the storage of its software and data. The issue then is whether the server creates a permanent establishment of an enterprise of one state in another state by virtue of the hosting arrangement. In other words, can the server be considered to be at the disposal of the enterprise? When an enterprise conducts its business through a website that is hosted on a server, such hosting arrangements do not result in the server and its location being at the disposal of the enterprise. This is because the enterprise does not have a physical presence at the location of the server as the website through which it operates is not tangible.

However, if the enterprise carrying on business through a website has the server at its own disposal, for instance if it owns (or leases) and operates the server on which the website is stored and used, then the place where that server is located could constitute a permanent establishment of the enterprise. However, this is still subject to three conditions. Firstly, the server must be ‘fixed’ at some location for a sufficient period of time in order to constitute a permanent establishment. Secondly, the meaning of permanent establishment still requires that the business of the enterprise should be wholly or partly carried

77 Arnold & McIntyre op cit note 6 at 153 note that it is through the website that an enterprise can have direct access to customers that have access to the Internet. By logging onto the website, such customers can select products for purchase from an online catalogue and buy them by filling out a form and charging the purchase to their personal credit card.
78 Ibid.
79 Buys & Cronje op cit note 69 at 303.
80 Paragraph 42.2 of the Commentary on art 5 of the OECD Model Tax Convention op cit note 8. See also Buys & Cronje op cit note 69 at 303; Arnold & McIntyre op cit note 6 at 153.
82 The fact that equipment might be moved around within a general location, such as an office, is not relevant in deciding whether it is a permanent establishment. Nor is it relevant that the equipment could be moved to some other location unless it is actually moved. See par 42.4 of the Commentary on art 5 of the OECD Model Tax Convention op cit note 8; Arnold & McIntyre op cit note 6 at 156.
on through the place where the server is located.\textsuperscript{83} And thirdly, a server will
be considered a permanent establishment of the enterprise only if the specific
exclusions stated in art 5(4) do not apply. In terms of this article, no permanent
establishment may be considered to exist where the e-commerce activities
carried on through a server in a given location are restricted to preparatory
or auxiliary activities.\textsuperscript{84} However, where such functions are in themselves the
core functions of the enterprise, or where they form an essential and significant
part of its business activities, they would go beyond preparatory or auxiliary
activities and so a permanent establishment would be deemed to exist. For
example, some Internet service providers are in the business of operating their
own servers for the purpose of hosting website or other applications for other
enterprises.\textsuperscript{85}

From the above it may be concluded that a physical permanent establishment
will be deemed to be present only when the enterprise carries on business
through a website that has a server at its own disposal, in a fixed location,
and when the business of the enterprise is not of a preparatory or auxiliary
nature. These factors make it difficult to apply the arm’s-length principle
to e-commerce transactions as it is difficult to determine the existence of a
permanent establishment. The result is that e-commerce enterprises are able to
supply goods and services at non-arm’s-length prices and avoid paying taxes in
a source country as they will not be deemed to have a permanent establishment
in that country.

5.2.2.2 Dependent Agent Permanent Establishments

The meaning of the term ‘permanent establishment’ also refers to the
presence of a dependent agent in a source country. In terms of art 5(5), a
dependent agent is one that acts on behalf of an enterprise and has the authority
to conclude contracts in its name in the other contracting state. The enterprise
is then deemed to have a permanent establishment in that state in respect of any
activities which the dependent agent undertakes for it, unless those activities
are of a preparatory or auxiliary nature. The issue in this regard is whether
the Internet service provider may be considered a dependent agent because it
provides the services of hosting the website of other enterprises that carry on
e-commerce through the servers owned and operated by that service provider.
According to the OECD Commentary,\textsuperscript{86} the Internet service provider will not

\textsuperscript{83} However, the fact that the enterprise does not require personnel at the location for the operation
of the equipment does not in itself mean there is no permanent establishment. See par 42.6 of the
Commentary on art 5 of the OECD Model Tax Convention; Buys & Cronje op cit note 69 at 303.
\textsuperscript{84} Such activities would include the provision of a communication link between supplier and customer,
the advertising of goods or services (such as the display of a catalogue of certain products), the relaying
of information through a mirror server for security and efficiency purposes, the gathering market data for
the enterprise and the supplying of such information to customers. See Arnold & McIntyre op cit note 6
at 155; Doernberg et al op cit note 74 at 212.
\textsuperscript{85} Paragraphs 42.8–42.9 of the Commentary on art 5 of the OECD Model Tax Convention op cit note 8.
See also Buys & Cronje op cit note 69 at 303.
\textsuperscript{86} Paragraph 42.10 of the Commentary on art 5 of the OECD Model Tax Convention op cit note 8. See
also OECD Report of the Committee on Fiscal Affairs Clarification on the Application of the Permanent
Establishment Definition in e-Commerce: Changes to the Commentary on the Model Tax Convention on
constitute a dependent agent of the enterprise to which the website belongs because it does not normally have authority to conclude contracts in the name of that enterprise. An Internet service provider normally constitutes an independent agent acting in the ordinary course of its business. This normally entails hosting the websites of many different enterprises.\textsuperscript{87} Even a website itself cannot be considered to be a dependent agent as per se it cannot accept orders. That can only be done by an operator in another jurisdiction over the Internet.\textsuperscript{88} The activities of websites are therefore limited and the information they supply is of preparatory or auxiliary nature. That excludes them from the term ‘permanent establishment’ in terms of art 5(4)(e) of the OECD Model Convention.

From the above, it may be concluded that as in the case of physical presence permanent establishments, it is difficult to apply the arm’s-length principle to the concept of ‘dependent agent permanent establishments’ in the e-commerce era. The result is that businesses that are conducted electronically can avoid paying taxes by engaging in transfer-pricing schemes.

5.3 The Effect of e-Commerce on the Meaning of ‘connected’ Parties

In terms of s 31(2) of the Income Tax Act, the acquirer of the goods and services has to be ‘connected’ to the supplier for it to be asserted that the price of the supplied goods or service is a non-arm’s-length one.

In terms of s 1 of the Act, the term ‘connected person’ in relation to a company includes

- it’s holding company;
- its subsidiary;
- any other company where both such companies are subsidiaries of the same holding company;
- any person who individually or jointly with any connected person in relation to himself, holds, directly or indirectly, at least 20 per cent of the company’s equity share capital;
- any other company if at least 20 per cent of its share capital is held by another company; or
- any other company which is managed or controlled by a person who a connected person in relation to the company.\textsuperscript{89}

In traditional commerce, tax administrators can establish a link or connection between taxpayers and related parties from documentation that relates to the registration of the relevant companies. However, in e-commerce it is not easy to

\textsuperscript{87} Arnold & McIntyre op cit note 6 at 156; par 42.10 of the Commentary on art 5 of the OECD Model Tax Convention op cit note 8.

\textsuperscript{88} Sudderds op cit note 81 at 262; Doernberg & Hinnekrems op cit note 81 at 133-6; Reinhardt Buys Cyber Law: The Law of the Internet in South Africa (2000) at 241. Buys (at 22-4) also explains the meaning of concepts such as ‘website’ and ‘server.’ He states that a ‘website’ is where data on the computer is hosted. A hosting computer stores the data that can be accessed through the Internet by a server. And a ‘server’ is a piece of software that delivers data from a host on request.

\textsuperscript{89} See s 1 par (d).
determine whether the companies concerned are connected. This is because the identity of the buyers and sellers who participate in Internet-based transactions is often irrelevant. Currently, it is not easy to link activities on the Internet to the parties associated with such activities. An Internet address or domain name indicates only who is responsible for maintaining that address and provides no link to the computer, its user who is corresponding on that address, or even the address where the computer is located. In such circumstances, it is difficult to apply the arm’s-length principle as the connected parties who could be involved in transfer pricing schemes, cannot be identified with ease.

5.4 The Effect of e-Commerce on the ‘price’ of Goods or Services

In order to apply the provision in s 31(2), the price for the goods or services that are supplied between the connected parties must be either less or more than ‘the price which the goods or services might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm’s length’. In other words, before applying the arm’s-length price, the Commissioner has to establish the non-arm’s-length price at which the goods or services were sold. Establishing this price in a traditional commerce transaction is usually not difficult as the parties concerned often leave a paper trail of the transactions they are involved in. e-Commerce transactions, however, do not normally reveal the value of a given transaction and this makes it difficult to determining how the prices charged for the relevant transactions were arrived at. Establishing the price of good or services is further complicated by the anonymous nature of electronic transactions and the electronic money or digital cash used to effect payment. A consumer can download electronic tokens from an on-line bank, and use those tokens to make purchases, thus leaving no paper or electronic trace as to the date and value of the transaction. This renders South Africa’s tax and auditing methods, based as they are on the physical evidence of a taxpayer’s financial records, prone to transfer pricing. The anonymous nature of electronic money also makes it easy for multinationals instantaneously and secretly to engage in fictitious transfer pricing without detection.

Even were the price of the goods or services can be determined, the ability to find uncontrolled comparable prices for goods and services transferred between associated companies in the e-commerce era is difficult. In order to compare the prices charged, it is necessary to analyse the functions performed by the companies in issue. According to Annexures A and B to SARS

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90 Doernberg & Hinnekens op cit note 81 at 388-9. See also Buys op cit note 88 at 246.
91 Hardesty op cit note 58 at 1-8; Ware & Roper op cit note 6 at 71.
92 Doernberg et al op cit note 74 at 390; Buys op cit note 88 at 248.
93 Buys & Cronje op cit note 69 at 306.
94 Hardesty op cit note 58 in par 10.01-10.4. Buys op cit note 88 at 301 notes that electronic money constitutes an electronic mechanism for the transfer of funds without the use of a deposit taking institution (such as a bank) or a third party; the process is characterised by the transfer of value itself.
95 Buys op cit note 88 at 300 notes that electronic coins are in the form of digitally signed numbers which are used in exchange for money from the user’s bank account.
96 Idem at 247 and 297.
97 SARS Practice Note No 7 op cit note 5 at 8.1.1-8.1.6; OECD ‘Transfer Pricing Guidelines’ op cit note 10 at 326 in par 54.
Practice Note No 7, a functional analysis is required in order to apply the Australian Tax Office’s four-step approach. Such an analysis would involve documenting the relative contribution of the various functions in order to identify the various economically significant activities and responsibilities. Among the functions that could be factored in are the designing, researching, manufacturing, assembling, servicing, purchasing, distributing, marketing, advertising, transporting, financing and managing involved in the transaction. Comparing the functions performed by different companies is difficult in the e-commerce era as functional analysis requires a close understanding of particular business functions. In e-commerce transactions, it may not be easy to identify and measure the contributions and functions of each company participating in the undertakings of the main business. For instance, the manner in which an intangible is delivered on a web page does not sometimes make it clear whether the function being performed is an advertisement for actual trading, whether it is subject to a copyright, or whether it is a provision of services.

5.5 The Effect of e-Commerce on the Methods Used to Arrive at an Arm’s-length Price

In order to apply the methods that are used so as to arrive at an arm’s length price, there must be a comparable uncontrolled transaction. There cannot be an adjustment in the absence of a transaction. The comparisons that are made between the relevant transactions are based on the separate-entity approach.

In traditional commerce, applying the separate-transaction approach to multinational enterprises has always posed certain difficulties. The reason is that multinationals are often integrated enterprises dealing in highly specialised goods and services or in intangibles. It is through integration that the multinational enterprises achieve economies of scale in aspects such as brand development and logistics. These measures of integration cannot be duplicated in the context of independent transactions conducted by two non-integrated businesses performing the same or similar transactions and selling the same or similar products.

In the context of e-commerce, applying the separate-transaction approach is made even more problematic as it is difficult to identify precisely what the transaction involves. The reason is that e-commerce makes transactions increasingly unique and incomparable to others. Even for those transactions that may be identified, e-commerce creates situations where separate transactions are so closely linked or continuous that they cannot be evaluated adequately.
on a separate basis.\textsuperscript{105} This is further augmented by the nearly instantaneous transmission of information, the speed at which transactions are concluded, and the increase in the bulk of transactions concluded. As a result, it becomes very difficult to find comparables for determining the value of a single electronic contribution in a highly integrated Internet transaction. The development of Intranets within multinationals has also put significant pressure on the traditional approach used to deal with non-arm’s-length transfer pricing, thus rendering the separate-transaction analysis virtually impossible.\textsuperscript{106}

For tax authorities, applying the arm’s-length principle to the bulk of e-commerce transfer-pricing cases that may arise, will be a daunting task requiring enormous administrative capacity. Traditionally only big companies with substantial capital had the ability to make significant sales outside South Africa. But now even the smallest e-commerce enterprise owned by an individual can sell on national and international markets. One simply cannot ignore the depletion of the country’s tax base that will result from the ensuing tax avoidance.

6 The Views of the OECD on the Challenges e-Commerce Poses to the Arm’s-length Principle

Despite the limitation of the arm’s-length principle in dealing with e-commerce transactions, it has been observed that experience among tax administrators in dealing with transfer-pricing matters in the field of e-commerce is at present limited. The OECD notes that it may be difficult for tax administrators to come to conclusions about transfer pricing in the e-commerce era without having made a detailed examination of e-commerce.\textsuperscript{107} However, the OECD Committee of Fiscal Affairs is of the view that the existing guidance in the ‘Transfer Pricing Guidelines’\textsuperscript{108} is capable of being applied to the specific factual circumstances of multinational groups conducting their business through electronic commerce.

The view of OECD member countries is that the arm’s-length principle is sound in theory since it provides the closest approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises.\textsuperscript{109} Even if it may not be straightforward to apply in practice, it generally produces appropriate results acceptable to tax administrators. A move away from this principle would destabilise international consensus and substantially increase the risk of double taxation. Many countries that apply the principle have now gathered experience that has produced a level of understanding among the business community and tax administrators. This

\textsuperscript{105} Schwartz op cit note 54 at 287.
\textsuperscript{107} Schwartz op cit note 54 at 287.
\textsuperscript{108} OECD ‘Transfer Pricing Guidelines’ op cit note 10. See also Schwartz op cit note 54 at 287.
\textsuperscript{109} OECD ‘Transfer Pricing Guidelines’ op cit note 10 at 325 in par 30-1. See also Hay op cit note 8 at 428 in par 38.
shared understanding is of great practical value in achieving the objectives of securing the appropriate tax base in each jurisdiction.\textsuperscript{110} This experience should be drawn on to develop the arm’s-length principle further, to refine its application, and to adapt it to cater for electronic commerce transactions. The view of the OECD is that at this stage it is better to sit back and see what develops.

Unfortunately tax payers cannot afford to do the same since they are required to address these issues at a practical level in order to set appropriate terms for intra-group transactions so that they produce the appropriate documentation that stands up to the scrutiny of tax authorities.\textsuperscript{111}

7 Conclusion and Recommendations

From the discussion above it is my view that the arm’s-length principle as enshrined in s 31(2) of the Income Tax Act, as well as the methods used to arrive at an arm’s-length price, cannot be relied on to curb tax avoidance that results from transfer pricing in the e-commerce transactions. However, I do support the OECD view that this principle is sound in theory as it provides the closet approximation of the workings of the open market in cases where goods and services are transferred between associated enterprises. But I do not support the view that the existing guidance in the “Transfer Pricing Guidelines”\textsuperscript{112} is capable of being applied in South Africa to the specific factual circumstances of multinational groups conducting their business through e-commerce.

The application of the arm’s length principle should be extended and refined to cater for e-commerce transactions.

With the enactment in South Africa of the Electronic Communications and Transactions Act, certain provisions relating to cryptography are in place to ensure the authenticity and integrity of Internet data and also to ensure that the source of such data may be correctly ascertained.\textsuperscript{113} For instance, s 38 of this Act provides that the authentication of the products or services of service providers will only be accredited if the electronic signature to which the authentication products or service relates, is uniquely linked to the user, is capable of identifying the user, is created using means that can be maintained under the sole control of that user, and will be linked to the data message to which it relates so that any change of the data may be detected. The section also provides that authentication of service providers will be accredited only if it is based on face-to-face identification of the user. In terms of ss 42 and 43, a supplier of electronic good and services must display certain information on the web site where the goods are offered, for instance, its full name and legal status, its physical address and telephone number, its website address and

\begin{itemize}
  \item \textsuperscript{110} OECD “Transfer Pricing Guidelines” op cit note 10 at 325 in par 30-1.
  \item \textsuperscript{111} Schwartz op cit note 54 at 287.
  \item \textsuperscript{112} Ibid.
  \item \textsuperscript{113} See the definition of cryptography in s 1 and also ss 29 and 30 of the Electronic Communications and Transactions Act.
\end{itemize}
e-mail address, its registration number, place of registration, names of office
bears, membership to any self regulatory body, and the physical address where
the supplier will receive legal documents. Sections 80 and 81 deal with the
appointment of cyber inspectors who have the power to inspect any website.
Although these sections may be used to identify parties to e-commerce
transactions, the preamble to the Electronic Communications and Transactions
Act shows that it was enacted, amongst other reasons, to ensure ‘the facilitation
and regulation of electronic communications and transactions’. On the whole,
however, the Act does not provide for taxation issues in respect to e-commerce
transactions.

I recommend that in order to ensure that the arm’s-length principle may
be effectively applied in the e-commerce era, a provision should be inserted
in the Income Tax Act that provides that the provisions of the Electronic
Communications and Transactions Act will be taken into consideration in
regard to transfer pricing in e-commerce transactions. This may also require
that s 31(2) be refined to accommodate e-commerce transaction. The section,
as it now reads, could for instance be expanded by adding a subsection that
could be worded as follows:

‘(b) Where goods or services are supplied or acquired electronically, the provisions of the
Electronic Communications and Transactions Act No. 25 of 2002 will be taken into consideration
in order to identify, trace, quantify and verify cross border e-transactions.’

My recommendation is based on the fact that developments in
telecommunications are taking place at a very fast rate. Soon most business
will migrate from traditional commerce to e-commerce. This requires the
amendment of current taxation principles, such as the arm’s-length principle,
that were developed to cover only situations where only a physical presence
in a jurisdiction was necessary to enforce tax laws and where transactions
involved only tangible products. By contrast, e-commerce transactions take
place in cyberspace where they are not confined to the geographical boundaries
of any given state, thus making them prone to tax avoidance. In my view, much
as it is necessary to sit back and wait to see how e-commerce develops so as not
to stifle its development, it is equally important to act fast and develop laws that
can accommodate e-commerce so as to protect our country’s tax base.