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University of the Witwatersrand

School of Accountancy

A research report submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce specialising in taxation.

A critical analysis of the South African tax and exchange control implications of royalty payments to non-residents.

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Date: 30 April 2018

ABSTRACT

Under the current tax regime in South Africa, non-residents are taxed on amounts received or accrued by such person from a source within the Republic. The general principle is that income derived from royalties on the exploitation of intellectual property is regarded as sourced in South Africa if the intellectual property was developed in South Africa.

South Africa imposes withholding taxes on royalties paid to non-residents on the exploitation of intellectual property regardless of actual source through the deeming source provisions incorporated in the Income Tax Act 58 of 1962. Withholding tax provisions are introduced in many tax systems across the world to facilitate the collection of taxes from non-residents and to limit the tax base erosion of that country through the tax deduction claimed by the South African taxpayer.

This research intend to critically analyse the definition of 'royalty' in terms of the current tax legislation in South Africa in the context of withholding taxes on royalties. The question arises mainly due to the difficulty in the interpretation of the definition of royalty as defined in section 49A of the Income Tax Act with respect to amounts accrued or received by foreign persons for the imparting of knowledge and information, widely known as 'know-how'.

The research will also provide a review of the nature of payments for computer software programs that are technically for the use or right of use of that computer software program. Other tax considerations covered in this research includes a discussion of the concept of effectively connected with a permanent establishment and some of the discrepancies between the domestic law and double tax agreements when a foreign person seeks to obtain relief for a reduction in the withholding tax rate.

This second part of this research report provides a comprehensive understanding of the exchange control regulations applicable to South African residents on the payment of royalty payments to non-residents. Furthermore, the researcher analyses the penalties that arise because of non-compliance with the regulations and what the impact is on the parties' contractual obligations.

KEYWORDS

Royalties; Intellectual property; Withholding tax on royalty; Non-resident; Foreign persons; Right of use; Imparting; Knowledge; Know-how; Computer software; Effectively connected; Permanent Establishment; Exchange control; Exchange control regulations; Non-compliance

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The rest of my immediate family for your support.

Lastly, a big thank you to the Almighty for given me the strength to persevere even in time of hardship.

DECLARATION

I, Mahommed Kubyane, declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. This research report has not been submitted for any other degree or examination at any other university.

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Mahommed Kubyane

14 May 2018

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CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

In 1994, the history of South Africa changed with the first democratic elections taking place. This paved the way towards a new democratic dispensation and a new constitution for the country. At the same time, South Africa was rapidly rejoining the global economy. This development required a careful analysis of the international dimensions of the tax system in South Africa by the new government. It was at this time that the Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa was then established. This Commission of Inquiry was chaired by Michael Mervyn Katz and was widely referred to as "the Katz Commission". The 'Fifth interim report of the commission of inquiry into certain aspects of the tax structure of South Africa'[1] (referred hereafter as 'Fifth Katz Report') dealt particularly with whether the tax system in South Africa should be based on the so-called residence or source principle. The Katz Commission was not the first of its kind to investigate the taxing system in South Africa.

In 1970, the Commission of Inquiry into Fiscal and Monetary Policy in South Africa recommended that the residence-based principle of taxation should be adopted by South Africa[2]. The commission was widely referred to as the 'Franzen Commission'. The commission indicated that more income was starting to flow into South Africa without it being taxed, the country's major trading partners were spread across the world and the Income Tax Act had already incorporated certain deeming provisions which was in itself a deviation from the source rule in any case. The move to residence taxation was however not made at that point even though the government had in principle accepted the recommendations of the Franzen Commission as outlined in the report on the Commission of Inquiry into the Fiscal and Monetary Policy.

[1] Department of Finance. 1997. Fifth interim report of the commission of inquiry into certain aspects of the tax structure of South Africa

[2] Cited in Naidoo. S. 2005. An Investigation of the Resident Based Tax System and its impact on the general scheme of the Income Tax Act No. 58 of 1962. Master's Research, University of Kwazulu Natal

The Fifth Katz Report described the residence principle as one where the country seeks to tax all the income derived by its residents, regardless of the source of the income. The source principle also requires residents to contribute to the state costs but it is premised on the basis that irrespective of residence, any person that derives income from that state, should also contribute to the costs of that state. It was noted in this report that in this complex world of international trade, no single principle can be applied in its pure form and thus most countries have modified these principles to arrive at a middle ground.

In the executive summary of the Fifth Katz Report submitted to the President of the Republic of South Africa in March 1997, the Katz Commission recommended that South Africa should continue to tax active income on a source basis. The Katz Commission however recommended a change in the taxation of passive income to taxing such income on a worldwide basis. This meant that all South African residents would pay tax on their passive income irrespective of the source of the income. Passive income typically includes investment income such as interest and royalties.

The Katz Commission further indicated that such a move would also protect the South African tax base from possible erosion when the exchange controls are lifted. The recommendation of the Katz Commission were also intended to further assist with protecting the tax base without relying on exchange control which would in turn uncouple the tax and exchange control regimes so that policy decisions on controls could then be made without concern for their effects on the tax base. In 2001, the residence taxation system was introduced in South Africa.

This research report provides a critical analysis of the South African tax and exchange control implications of royalty payments to non-residents. Under the current tax regime in South Africa, non- residents are taxed on amounts received or accrued by such person from a source within the Republic. The basic principle with regard to the source of royalties was established in the *Millin v CIR* case (1928) where it was held that the true source of royalties accruing from a book was the author's wits, labour and intellect. It follows that where the author applies his wits, intellect and labour, that would be where the true source of the

income is. The general principle is that income derived from royalties on the exploitation of Intellectual Property (IP) is regarded as sourced in South Africa if the IP was developed in South Africa. In a situation where the IP was developed outside the Republic, the payments would ordinarily not be sourced in South Africa and thus not taxed in South Africa.

Like most residence system, South Africa imposes withholding taxes on royalties paid to non-residents regardless of the actual source through the deeming source provisions incorporated in the Income Tax Act 58 of 1962 (the Act). The Fifth Katz Report summarizes the current tax provisions in relation to the taxation of royalties as follows:

- Where a non-resident receives or accrues royalties from South Africa which are not of a South African source but relate to the use in South Africa of the relevant intangible, the deemed source provisions and withholding tax mechanism would apply ; and
- Where a non-resident derives South African source royalties [that is, where the intellectual property was in fact developed in South Africa], the normal tax principles shall apply to determine whether the income is attributable to a permanent establishment. If the income is not attributable to a permanent establishment, the income would only be subjected to withholding taxes.

1.2 PROBLEM STATEMENT

A critical analysis of the definition of 'royalty' in terms of the current tax legislation in South Africa in the context of withholding taxes on royalties and exchange control implications. The main problem arises mainly due to the difficulty on taxpayers in the interpretation of the definition of royalty as defined in section 49A of the Act with respect to amounts accrued or received by foreign persons:

> for the imparting or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information.

Withholding provisions are introduced in many tax systems across the world to facilitate the collection of taxes from non-residents and to limit the tax base erosion of that country through the tax deduction claimed by the South African taxpayer. Therefore, clarity is sought in this research report as to the nature of payments that would qualify as consideration for the imparting or the undertaking to impart scientific, technical, industrial or commercial

knowledge or information. It is noted that the Act does not provide much guidance on the nature of payments that would be considered payment for the imparting or undertaking to impart, the rendering or the undertaking to render such knowledge or information as envisaged by the section 49A of the Act. The recent draft Interpretation Note on withholding taxes on royalty also does not provide much guidance in this regard.

The research will also provide a review of the nature of payments for computer software that are technically for the use or right of use of that computer software. Other tax consideration covered in this research includes a discussion of what is meant to be effectively connected with a permanent establishment and some of the discrepancies between the domestic law and double tax agreements when a foreign person seeks to obtain relief for a reduction in the withholding tax rate.

This second part of this research report provides a comprehensive understanding of the exchange control regulations applicable to South African residents on the payment of royalty payments to non-residents. The report outlines the specific exchange control requirements relating to royalty payments to non-residents for computer software, payments to related parties, and royalty payments relating to licensee agreement involving local manufacture of goods. Furthermore, the researcher analyses the penalties that arise due to non-compliance with the regulations and what the impact is on the parties' contractual obligations.

1.3 RESEARCH METHODOLOGY

The research method adopted is of a qualitative, interpretive nature, based on a detailed interpretation and analysis of amongst other things, case law.

An extensive literature review and analysis will be undertaken that includes the following sources: Cases, Electronic databases, Electronic resources – internet, Journals, Magazine articles, Publications, Statutes, and Government publications.

CHAPTER 2: BACKGROUND ON WITHHOLDING TAX ON ROYALTY

2.1 WITHHOLDING TAX REGIME

South Africa taxes residents on their worldwide income and non-resident on income accrued or received from a source within South Africa. South Africa imposes a withholding tax (WHT) on royalty at the rate of 15% of the amount paid by any person to a foreign person to the extent that the amount is deemed to be from a source within the Republic in terms of the provision of section 9 of the Act. The WHT provisions on royalty are provided for in Part IVA of the Act. WHT provisions are introduced in many tax systems across the world to facilitate the collection of taxes from non-residents and to limit the tax base erosion of that country through the tax deduction claimed by the South African taxpayer. It is often difficult if not impossible for tax authorities to collect income taxes chargeable on the earnings derived by non-residents from business carried out in the source country. This is due to the fact that the tax authorities of one county have no jurisdiction over non-residents of that country and thus would have to rely on the assistance of foreign governments. This is particularly so with regard to passive income.

Moreover, the effectiveness of the WHT regime is also depended on the presence of double tax treaties. For an optimal effective South Africa's WHT regime, it will have to be backed up with double tax treaty reforms, through the re-negotiation of older treaties or signing protocols to take into consideration the withholding taxes that are now in place (Oguttu, 2014). Most South African treaties are based on the Organization for Economic Co-operation and Development (OECD) Model Tax Convention, which generally favours the interest of the developed countries. It is therefore imperative that negotiators of treaties re-negotiate better rates for South Africa if we are to have an optimal WHT regime that prevents the erosion of the South African tax base.

The OECD has, as its main purpose:

> to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation[3].

A recent indication of the difficulty faced by the South African tax authorities with regard to collection of taxes on non-resident and the erosion of the tax base was demonstrated by the tax proposal made in the Budget Speech of 2013. The Tax Laws Amendment Bill, 2013 (2013 TLAB) introduced a WHT on cross boarder service fees at a WHT rate of 15% on the amount of any service fee that is paid by any person to, or for the benefit of, any foreign person to the extent that the amount is regarded as having been received by or accrued to the foreign person from a source within South Africa. It is important to note that the proposed WHT services was intended to not included services fees that would qualify as royalty as defined (Oguttu, 2014).

The introduction of the WHT on service fees was a clear attempt by the tax authorities to curb the erosion of the South African tax base as this service fees generate local deductions by the South African taxpayer. The Explanatory Memorandum on the 2013 TLAB indicated that the main purpose of this WHT tax was to identify and collect revenue from non-residents who provide technical, managerial or consultative services within a South African source that fall outside the normal tax and to prevent the potential for the erosion of the South African tax base. The withholding tax was ultimately set to commence on 1 January 2017. The Tax Laws Amendment Bill, 2016 (2016 TLAB) however repealed the introduction of the WHT on services fees. The 2016 TLAB explained the reason for the repeal to be due to the South African Revenue Service (SARS) Notice[4] issued on 3 February 2016, which provided for a revised list of reportable arrangement[5].

The SARS notice indicated that an arrangement for the rendering of consultancy, construction, engineering, installation, logistical, managerial, supervisory, technical or

[3] Cited from Du Plessis, I. 2014. A South African Perspective on Some Critical Issues Regarding the OECD MTC on Income and on Capital, With Special Emphasis on its Application to Trusts.
[4] SARS Notice 140 of the Government Gazette no 39650
[5] Section 35(2) of the Tax Administration Act, 2011: An 'arrangement' is a 'reportable arrangement' if the Commissioner has listed the 'arrangement' in a public notice.

training services to a South African resident or a non-resident having a permanent establishment in South Africa, in terms of which arrangement a non-resident was, is, or is anticipated to be physically present in South Africa in connection with or for purposes of rendering the services and the expenditure incurred or to be incurred in respect of the services exceeds or is anticipated to exceed R10 million, is a reportable arrangement in terms of the Tax Administration Act[6] (TAA) provided that it does not qualify as 'remuneration' for employees' tax purposes.

The proposed introduction of the WHT on service fees and this new reportable arrangement would, if ran concurrently, result in additional administrative functions for SARS and a compliance burden for South African taxpayers. The Explanatory Memorandum to the 2016 TLAB indicated that the two regimes were virtually aimed at achieving the same goal, that is, identifying and collecting revenue from non-resident taxpayers who provide technical, management or consulting services. As a result, the 2016 TLAB had the effect of repealing the WHT on service fees as these payments would now be dealt with under the reportable arrangement provisions of the TAA. Effectively, the taxation of non-resident was still a matter for careful consideration but through the reportable arrangement regime as outlined in the TAA.

2.2 TAXATION OF ROYALTY INCOME FOR NON-RESIDENTS

In 2001, South Africa moved to a residence base taxation. Effectively the definition of 'Gross Income' in the Act was amended to tax residents of South Africa on all their worldwide income and tax non-residents on their South African sourced income.

In terms of section 1 of the Act, **'gross income'** is defined as follows:

> in relation to any year or period of assessment, means—
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,

[6] Tax Administration Act, 2011 (Act 28 of 2011)

during such year or period of assessment, excluding receipts or accruals of a capital nature,

This part of the research report focuses on part (ii) of the definition of gross income. Specifically, the researcher elaborates more on the following two points:

- In the case of any person other than a resident ; and
- From a source within the Republic

The terms 'resident' is defined in section 1 of the Act as follows;

"**resident"** means any—
(a) natural person who is—
  (i) ordinarily resident in the Republic; or
  (ii) not at any time during the relevant year of assessment ordinarily resident in the Republic, if that person was physically present in the Republic (widely known as the physical presence test)
(b) person (other than a natural person) which is incorporated, established or formed in the Republic or which has its place of effective management in the Republic.

2.2.1 ORDINARILY RESIDENT

The concept of 'ordinarily resident' is not defined in the Act. The courts have over the years interpreted the words to mean the country to which a natural person would naturally and as a matter of course return from his world's wonderings. It is considered to be a person's usual or principal residence. Interpretation Note 3[7] summarizes the meaning that has been ascribed by the courts over the years to the concept of 'ordinarily resident' by the courts to refer to—

- living in a place with some degree of continuity, apart from accidental or temporary absence. If it is part of a person's ordinary regular course of life to live in a particular place with a degree of permanence, he/she must be regarded as ordinarily resident;
- the place where his/her permanent place of abode was, where his/her belongings were stored, which he/she left for temporary absences and to which he/she regularly returned;
- the residence must be settled and certain and not temporary and casual;
- that ordinarily resident is narrower than resident. A person is ordinarily resident where he/she normally resides, apart from temporary/occasional absences.

[7] SARS Interpretation Note 3.2002. Resident: Definition in relation to a natural person – Ordinarily Resident.

One cannot place a definitive meaning of the term 'ordinarily resident'. Each case is to be considered on its own merit based on own facts and circumstances taking into the account the tax principles already established through case law. It is important to highlight that physical presence is not a prerequisite for one to be ordinarily resident in South Africa. Interpretation Note 3 provides two indicators that should be considered, that is, the intention to be ordinarily resident in the Republic and steps indicating that one is intending or has intended to be ordinarily resident in South Africa. There is no fixed list of steps that could prescribe whether one is ordinarily resident in a country or not.

2.2.2 PHYSICAL PRESENCE TEST

The physical presence test is based on the number of days that a natural person is physically present in South Africa regardless of the nature or purpose of the visit. In a year that a person is ordinarily resident, the physical presence test will not be applicable as the concept of 'ordinarily resident' supersedes the physical presence test. The requirements refer to the number of days that a natural person must actually be present in South Africa, during a year of assessment and also during the five years of assessment preceding the year of assessment under consideration.

The Act indicates that a person must be physically present in the Republic for a period or periods exceeding –

(i) 91 days in aggregate during the relevant year of assessment;
(ii) 91 days in aggregate during each of the five years of assessment preceding that relevant year of assessment; and
(iii) 915 days in aggregate during the five preceding years of assessment.

2.2.3 NON-RESIDENT

Part 2.2.1 and 2.2.2 above illustrates the underlying principle with regard to the taxation of income (including royalty income) of any person in South Africa. A resident of South Africa will be taxed on any royalty income received or accrued regardless of source. A non-resident is only taxed on royalty income received or accrued to them only to the extent that such income is derived from a source with the Republic. The term non-resident is not defined in

the Act. The definition of gross income however does indicate "in the case of any person other than a resident", gross income will comprise of their South African sourced income.

Therefore, it is imperative that a natural person determines whether they are a resident of South Africa either as a result of being 'ordinarily resident' in South Africa or as a result of meeting the physical present test requirements. In any other case, a natural person is deemed to be a non-resident and thus will include in gross income their South African actual sourced income or South African deemed source income. The deeming provisions are incorporated into the Act through section 9 of the Act.

For a person other than a natural person, a non-resident will be where the juristic person is incorporated, established or formed outside the Republic or it has its place of effective management outside of the Republic.

2.2.4 GROSS INCOME – ROYALTY PAYMENTS

It is imperative to understand the gross income inclusion relating to royalty payments. In terms of the gross income definition as outlined in section 1 of the Act, there are certain amounts that will be included in gross income regardless of whether they are capital in nature or not. The researcher has repeated the definition of 'gross income' below for ease of reference and clarity on the above point.

In terms of section 1 of the Act, '**gross income**' is defined as:

> in relation to any year or period of assessment, means—
>
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such person from a source within the Republic,
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature, *but including, without in any way limiting the scope of this definition, such amounts (whether of a capital nature or not) so received or accrued as are described hereunder, namely* (own emphasis)—
>
> …

(g) any amount received or accrued from another person, as a premium or consideration in the nature of a premium—
(i) …
(ii) …
(ii)bis for the use or the right of use of any motion picture film or any film or video tape or disc for use in connection with television or any sound recording or advertising matter connected with such motion picture film, film or video tape or disc; or
(iii) for the use or right of use of any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any model, pattern, plan, formula or process or any other property or right of a similar nature;

(gA) any amount received or accrued from another person as consideration for the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or for the rendering of or the undertaking to render any assistance or service in connection with the application or utilization of such knowledge or information;

The purpose of the special gross income inclusions is not to limit the scope of the gross income definition but rather to indicate that regardless of whether the special inclusion amounts are capital in nature or not, they will still be deemed to form part of gross income. For any non-resident, there is an additional requirement in order for the amount to be included in their income. The amount must be from a source within the Republic. The researcher is of the view that the special inclusion paragraph are in no way or form intended to deem any amount to be from a source within the Republic. This necessitated the need for the legislator to provide specific deeming rules in terms of section 9 of the Act, which deems certain amounts to be from a source within the Republic. These deeming rules are discussed below. The researcher will first discuss the principle of 'source' in relation to royalty amounts and secondly discuss the deeming provision in relation to royalty amounts.

2.2.5 SOURCE

Non-resident are taxed only on royalty income received or accrued to them from a source within the Republic or from a sourced deemed to be from the Republic. There is no definition of the concept of source in the Act. The courts have provided some guidance on this concept but no definitive rule has been provided due to the difficulty in defining the word source.

The principle meaning of source has been formulated by the courts. In *CIR v Lever Brothers and Unilever Ltd*[8] it was established that in relation to the receipt of money, source would be the originating cause of the receipt of that money. The case involved an interest payment made by a South African resident company to an overseas creditor. The contentious issue was whether the interest income received by the creditor constituted income from a South African source. The court held that it was probably an impossible task to formulate a definition that would furnish a universal test for determining whether an amount is received from a South African source. Watermeyer CJ indicated the following in delivering his judgement of the Appellate division of the Supreme Court:

> The word source has several possible meanings. In this section it is used figuratively, and when so used in relation to the receipt of money one possible meaning is the originating cause of the receipts of the money, another possible meaning is the quarter from which it is received.[9]

The underlying principle that came out of the case is that the originating cause of income is determined by taking two factors into account, that is, what gives rise to the income (in other words, what is the originating cause), and where is the originating cause located.

The source principle in relation to royalties was laid down in *Millin v CIR* case (1928) as indicated in Chapter 1. It was held that the true source of royalties accruing from a book was the author's wits, labour and intellect. It follows that were the author applies his wits and labour, that would be were the true source of the income is found or emanates. Applying the same principles coming from the *CIR v Lever Brothers and Unilever Ltd*, the originating cause of the royalty would be the wits, labour and intellect. The location would be where the above wit, labour and intellect is utilized.

[8] Cited in Naidoo. S. 2005. An Investigation of the Resident Based Tax System and its impact on the general scheme of the Income Tax Act No. 58 of 1962. Master's Research, University of Kwazulu Natal
[9] Cited in Naidoo. S. 2005. An Investigation of the Resident Based Tax System and its impact on the general scheme of the Income Tax Act No. 58 of 1962. Master's Research, University of Kwazulu Natal

2.2.6 SOURCE - DEEMING PROVISIONS

To provide certainty in the application of the tax source principles, certain deeming provisions are incorporated into the Act. These provisions deem certain amounts received to be from a source in the Republic and thus would form part of gross income. This part of the report elaborates on the taxation of royalty amount received or accrued as defined in section 49A of the Act. The deeming provisions in relation to 'royalty' are outlined in section 9(2)*(c),(d),(e) or (f)* of the Act.

For purposes of the interpretation of section 9 of the Act, section 9(1) defines the term 'royalty' as: "any amount that is received or accrues in respect of the use, right of use or permission to use any intellectual property as defined in section 23I."

Section 23I of the Act defines '**Intellectual Property**' as:

> means any—
> (a) patent as defined in the Patents Act including any application for a patent in terms of that Act;
> (b) design as defined in the Designs Act;
> (c) trade mark as defined in the Trade Marks Act;
> (d) copyright as defined in the Copyright Act;
> (e) patent, design, trade mark or copyright defined or described in any similar law to that in paragraph(a), (b), (c) or (d) of a country other than the Republic;
> (f) property or right of a similar nature to that in paragraph (a), (b), (c), (d) or (e); and
> (g) knowledge connected to the use of such patent, design, trade mark, copyright, property or right;

Section 9(2) deems any of the following amounts received by or accrued to a person to be from a source within the Republic;

> …
>
> (c) constitutes a royalty that is attributable to an amount incurred by a person that is a resident, unless that royalty is attributable to a permanent establishment which is situated outside the Republic;
> (d) constitutes a royalty that is received or accrues in respect of the use or right of use of or permission to use in the Republic any intellectual property as defined in section 23I;
> (e) is attributable to an amount incurred by a person that is a resident and is received or accrues in respect of the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information, unless the amount so received or accrued is attributable to a permanent establishment which is situated outside the Republic;
> (f) is received or accrues in respect of the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information for use in the Republic, or the rendering of or the undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information;

Therefore, any amount of the above nature will be deemed to form part of the gross income of a non-resident for purposes of their South African tax liability if received by that non-resident regardless of the actual source of that amount. This provides certainty to South African taxpayers and thus assist with providing transparent information to potential international investors wanting to invest in South Africa. It is important to note that section 9(2)(*c*) and (*e*) indicate that the relevant amounts will not be deemed to be from a source from the Republic if the amounts paid for the benefit of the foreign person are attributable to that foreign person's permanent establishment which is situated outside the Republic. The concept of permanent establishment is discussed in more detail below under Chapter 4 below.

2.3 WITHHOLDING TAX ON ROYALTY

Part IVA of the Act provides for the withholding tax regime with regard to royalties paid to foreign persons and is applicable to royalty paid or that become due and payable on or after 1 July 2013.

Section 49B of the Act provides a levy of withholding tax on royalties calculated at the rate of 15 per cent of the amount of any royalty that is paid by any person to or for the benefit of any foreign person to the extent that the amount deemed to be from a source within South Africa.

The term royalty is defined in section 49A of the Act and means any amount that is received or accrues in respect of—

(a) the use or right of use of or permission to use any intellectual property as defined in section 23I; [*Discussed in paragraph 3.4 below]* or

(b) the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information. *[Discussed in paragraph 3.5 below]*

Effectively, the definition of royalty as outlined in section 49A aligns with the gross income special inclusions in terms of paragraph *(g)(*ii bis), *(g)*(iii) and (*g*A) of the definition of gross income as outlined above under the heading 'Gross Income – Royalty Payments'.

Furthermore, the provision of section 49B indicate that it is applicable on amounts deemed to be from a source within the Republic. This is relevant as the section is only applicable to royalty payments to a 'foreign person'. A foreign person is defined in that part of the Act as any person that is not a resident. The definition of royalty for purposes of the withholding tax on royalty is critically analysed in more detail in chapter 3.

2.4 TAX EXEMPTION FROM GROSS INCOME INCLUSION

Section 49B(3) of the Act indicates that the withholding tax on royalty is a final tax. In the absence of any other income by the non-resident, SARS has indicated that the non-resident does not have to submit any annual income tax return regarding the royalty payment received (SARS Draft Interpretation Note on Withholding tax on Royalties, page 9).

Section 10(1)*(l)* of the Act provides a tax exemption against the gross income inclusion for the non-resident. The exemption is not applicable if the royalty is paid to a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve month period preceding the date on which the amount is received by or accrues to that person, or if the IP or the knowledge/information in respect of which that royalty is paid is effectively connected with a permanent establishment of that person in the Republic.

If the royalty paid is effectively connected to a permanent establishment in South Africa, the non-resident is also exempt from the withholding tax in terms of section 49D of the Act. The non-resident will therefore be obliged to pay tax at the normal rates on that amount of royalty paid with a deemed South African source.

CHAPTER 3: ROYALTY IN TERMS OF PART IVA OF THE ACT

In this chapter, the researcher critically analyses in detail the definition of 'royalty' as defined for purposes of Part IVA of the Act. The definition is broken down into the following components that are discussed separately below.

Royalty

- any amount;
- received or accrued in respect of;
- use or right of use of Intellectual Property; or
- imparting of or undertaking to impart any scientific, technical, industrial or commercial knowledge or information, the rendering or undertaking to render any assistance or services in connection with such knowledge or information.

3.1 AMOUNT

It is held that even though something might not be turned into money, it does not mean it does not have a monetary value. (*C:SARS v Brummeria Renaissance*, 2007).

3.2 RECEIVED OR ACCRUED

In *Geldenhuys v CIR (1947),* the court indicated that the words 'received by' means "received by the taxpayer on his own behalf for his own benefit".

In *WH Lategan v CIR (1926),* the court stated that the word accrued merely meant, "to which he has become entitled to"

3.3 INTELLECTUAL PROPERTY IN TERMS OF SECTION 23I

An amount is considered 'royalty' payment if it relates to the use or the right of use or permission to use any IP. The definition of 'royalty' in terms of Part IVA of the Act is very

specific of the nature of IP it encompasses. It makes reference to IP as defined in section 23I of the Act.

The definition in terms of section 23I of the Act is outlined above in chapter 2. Each component is discussed in detail below.

3.3.1 PATENT

The term 'patent' as defined in the Patents Act 57 of 1978 means "a certificate in the prescribed form to the effect that a patent for an invention has been granted in the Republic".

3.3.2 DESIGN

The term 'design' as defined the Designs Act 195 of 1993 means "an aesthetic design or a functional design"

An 'aesthetic design' means "any design applied to any article, whether for the pattern or the shape or the configuration or the ornamentation thereof, or for any two or more of those purposes, and by whatever means it is applied, having features which appeal to and are judged solely by the eye, irrespective of the aesthetic quality thereof"

A 'functional design' means "any design applied to any article, whether for the pattern or the shape or the configuration thereof, or for any two or more of those purposes, and by whatever means it is applied, having features which are necessitated by the function which the article to which the design is applied, is to perform, and includes an integrated circuit topography, a mask work and a series of mask works"

3.3.3 TRADE MARK

The term 'design' as defined the Trade Marks Act 194 of 1993 (Trade Mark Act), means "other than a certification trade mark or a collective trade mark, means a mark used or

proposed to be used by a person in relation to goods or services for the purpose of distinguishing the goods or services in relation to which the mark is used or proposed to be used from the same kind of goods or services connected in the course of trade with any other person".

'certification trade mark' means a mark registered or deemed to have been registered under section 42 of the Trade Marks Act.

'collective trade mark' means a mark registered under section 43 of the Trade Mark Act.

3.3.4 COPYRIGHT

The term 'copyright' as defined in the Copyright Act 98 of 1978 (Copyright Act) means "copyright under this Act".

3.3.5 INTELLECTUAL RIGHTS REGISTERED IN ANOTHER COUNTRY

In the United Kingdom a creator's artistic, literary, dramatic and musical work is protected by the Copyright, Designs and Patents Act, 1988. By applying paragraph (e) of the definition of 'intellectual property' in section 23I(1), the draft Interpretation Note on prohibition of deductions for certain intellectual property indicate that these works will also be regarded as intellectual property as defined under section 23I. Therefore, any payments for use or right of use of this IP would fall within the ambit of Part IVA of the Act and be subject to withholding taxes on royalties. (Draft Interpretation Note on prohibition of deductions for certain intellectual property, page 3)

Ultimately, any payments for use or right of use of this IP would fall within the ambit of Part IVA of the Act and be subject to withholding taxes on royalties.

3.3.6 PROPERTY OR RIGHT OF A SIMILAR

The definition of IP provides that property or right of similar nature to any patent, design, trade mark or copyright are considered to be IP as defined. The concept of "property or right of a similar nature" was analysed by the courts in a recent Supreme Court of Appeal case between the *Commissioner of SARS v SA Silicone Products (Pty) Ltd* (2004).

The issue that was in dispute in the case was whether an amount of R14.5 million claimed by the respondent as a deductible allowance in terms of section 11 (*g*A)(iii) of the Income Tax Act 58 of 1962 in its return for the 1995 financial year was improperly disallowed by the SARS. The allowance was claimed by the taxpayer under the then section 11(*g*A)(iii) of the Act that allowed for a deduction of any expenditure incurred by the taxpayer in acquiring by assignment from any other person any such patent, design, trade mark or copyright, or in acquiring any other property of similar nature or any knowledge connected with the use of such patent, design, trade mark, copyright or other property or the right to have such knowledge imparted if it was in the production of such taxpayer's income.

The respondent (being the taxpayer) negotiated the acquisition of the business of DB Silicones CC (hereafter referred to as 'DBS'). DBS business carried on a business of marketing silicone products under licence from Dow Corning Corporation. A trade mark attorney was instructed to value the IP being bought with the DBS business. The value (R14.5 million) determined by the attorney comprised of the following:

First, the Dow Corning products denoted by its trade marks and the right to repackage and sell under the trade marks, and, second, the distribution network established by DBS which was embodied in distribution agreements with sub-distributors and confidential information and copyright material in the form of customer lists, customer consumption patterns and product application know-how. The court however noted that the actual sale agreement did not mention the second part of the valuation being for the "Customer connection".

The Attorney regarded both components of the value as IP. The attorney indicated that DBS did not own the Dow Corning trade marks, but rather enjoys certain transferable rights. In 1995, after the conclusion of the sale agreement between DBS and the taxpayer, Dow Corning consented to the assignment of the trade mark licence agreement to the taxpayer, 'subject to all rights and obligations contained in the said Trademark License'. The taxpayer submitted that the trade mark licence was property 'similar in nature' to a trademark.

In delivering his judgement, Heher JA stated the following:

> The expression, properly interpreted, requires, in my view, that any property which is similar in nature shall possess fundamental characteristics common to those possessed by the specifically identified properties; minor or superficial similarities will not of themselves suffice.

Heher JA went further and stated that the assignment of a trade mark licence was not 'property similar in nature' to a trade mark. Heher JA stated that the licence cannot be considered to be intellectual property but rather merely the grant of a temporary right of use, conferring no monopoly in the hands of the licensee and neither proprietary interest nor the protection accorded by law to such an interest. The court indicated that the limited power of exploitation of the marks which the licence confers is quite insufficient to justify the description of the licence as 'similar in nature'.

Each case will need to be determined on its own merits based on the facts at hand. The underlying principle taken from this case with regard to what would constitute 'property of right of a similar nature' is that such property or right must possess fundamental characteristics common to those possessed by the specifically identified properties.

3.4 THE USE OR RIGHT OF USE

For the amount to qualify as royalty, it must be a consideration for the 'use of or right of use' of IP. In most instances, it is easy to determine whether a payment is received for an outright sale of one's asset or for a right of use. In certain instances, the facts are complex and thus require special analysis of the intention of the parties with regard to the transaction as a whole to determine whether the agreement is that of a licence or that of a cession of an asset.

This point was elaborated in the Zimbabwean case of *Vacu-Lug (Pvt) Ltd v Commissioner of Taxes* (1963). The case involved Vacu-Lug (Pvt) Ltd, a company registered in Southern Rhodesia, which entered into a written agreement with an english company, Vacu-Lug Traction Tyres (Overseas) Ltd. Vacu-Lug Traction Tyres (Overseas) Ltd is hereafter referred to 'Vacu-Lug Company'. In terms of the contract, the Vacu-Lug Company granted to the Vacu-Lug (Pvt) Ltd certain rights in Southern and Northern Rhodesia, to re-lug and repair tyres by a process known as the American Rawls Vacu-Lug Process. On 18th December 1956, Vacu-Lug Company and the Vacu-Lug (Pvt) Ltd together entered into a written agreement with a Northern Rhodesia Company, Copperbelt Tyre Services Ltd (hereafter referred to as 'CTS').

This agreement gave to CTS certain rights to operate the process in Northern Rhodesia. Vacu-Lug Company is a sales agent and a representative of another company in the United States for the sale of the rights to operate the process together with the equipment necessary to operate the process in all parts of the world except the North and South American Continents and the Islands adjacent thereto and the territories of the United States of America. As such sales agent and representative, they had acquired the knowledge and technical information necessary to operate the process.

Vacu-Lug is a registered trade mark and the Vacu-Lug process of re-lugging and repairing tyres is a patented process. Vacu-Lug Company has agreed to communicate to the CTS the knowledge and technical information necessary to operate the process in the territory and to sell or let on hire to the purchaser the equipment necessary to operate the process for a consideration and upon and subject to the certain terms and conditions. Furthermore, upon receipt by CTS of the Vacu-Lug plant, Vacu-Lug Company shall send to the premises of the CTS a qualified technical representative to supervise the erection and installation of the plant. As the Vacu-Lug Company has the licence to operate in the territory that CTS wants to operate in, a sub-lease agreement was then entered into between the Vacu-Lug Company, Vacu-Lug (Pvt) Ltd and CTS where the Vacu-Lug Company grants a sub-licence to CTS with the approval of Vacu-Lug (Pvt) Ltd.

In compensation for the sub-licence and for sharing of knowledge and technical information necessary to operate the process, CTS paid $5000 to the Vacu-Lug Company. On submission of its 1957 income tax return, Vacu-Lug Company held that the $5000 was only payment for the 'know-how' which they had disposed finally and completely to CTS. Vacu-Lug Company indicated in the court case that if the $5000 included a right to operate the patented process or the right to use a trade mark, the agreement had the effect of disposing of all rights it ever had in the territory of CTS. Therefore such an outright sale was a disposal of rights under a cession as compared to a sub-lease.

In delivering the judgement, Beadle CJ rejected the Vacu-Lug Company's first assertion that the $5000 was only for 'know-how' as the contract was quite clear that something more than a mere know-how was received by CTS. Beadle CJ acknowledged that the nature of know-how is such that once parted with, it can never be recovered.

Furthermore, the Beadle CJ cited the *Californian Copper Syndicate case, 41 Sc. L.R. 694,* and suggested a broader test as: "Is the transaction in substance a parting by the company with part of its property for a purchase price or is it in substance a gain made by an operation of business in carrying out a scheme for profitmaking?"

Beadle CJ indicated that the agreement used words like "sub-licence", "grants licence to operate". Further, the agreement read as a whole, indicate that the $5000 is paid to the Vacu-Lug Company by CTS and nothing to Vacu-lug (Pvt) Ltd, being the one who licenced the right to Vacu-Lug Company and Vacu-Lug Company now having sub-let the right to CTS. Further, the agreements provide for special payment terms, a service fee which is based on every pound of lug stock used. This payment was seen to take the equivalent of a royalty paid for the use of a process. Beadle CJ indicated that the intention of the agreement as whole must be given regard and when read as whole, he was satisfied that Vacu-Lug Company was not outright disposing its assets in the territory of CTS but rather putting these assets to productive use. Such an agreement resembles that of a sub-lease rather than that of a cession.

Therefore, the agreement was in effect for a right of use of a particular right and not for an outright sale of that right.

Right of use – guidance from OECD

As indicated in Chapter 2 of this research report under the discussion of the withholding tax regime in South Africa, most of South African treaties are based on the OECD Model Tax Convention (OECD MTC) even though South Africa is not a member state**.** This research report address the implication of royalty payments to non-residents and thus the application of Double Tax Agreements (treaties) is an important consideration. The text of the OECD MTC is generally accepted by South Africa with little adjustments. Therefore, the commentary to the OECD MTC has a persuasive nature in the interpretation of the majority of treaties signed by South Africa. Double tax agreements signed by South Africa are part of the South African legislation as indicated in terms of section 108 of the Act.

In *SIR v Downing* (1975), Corbett JA drew on the commentary of the OECD MTC in interpreting the provisions of the Double Tax Agreement entered into between South Africa and Switzerland. Corbett JA indicated that this model has served as the basis for the veritable network of double taxation conventions existing between South Africa and other countries.

In ITC 1878 (2015), Vally J indicated that the explanations provided in the commentary on the OECD MTC are of immense value in understanding or interpreting any article contained in the treaties. This part of the research report deals specifically with the commentary provided for regarding the concept ‘use of’ or ‘right of use’ of what is IP.

In terms of Article 12(2) of the OECD MTC, the term ‘royalties’ as used in this Article means:

> payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Paragraph 8 of the commentary to Article 12 of the OECD MTC indicates that the definition of royalty applies to consideration for the use of, or the entitlement to use, rights, regardless of whether they have been, or are required to be registered. The commentary further indicates that the definition does not include payments that are made to someone else who does not own the right or the right to use it.

It is important to be able to identify payments relating to a transfer of full ownership of an element of a property. Such payments are not for the 'use of' or 'right of use' of such property and thus will not form part of royalty. The identification of what is payment for 'use of or right of use' against 'payment for alienation of property' is a complex area and thus would need to be considered on a case by case basis. Paragraph 8.2 of the commentary to Article 12 provides an important consideration with regard to nature of a payment. It indicates that the important character of the transaction involving property as an alienation cannot be changed by the form of the consideration or by the fact that the payments are related to a contingency.

Furthermore, paragraph 10.2 of the commentary to Article 12 of the OECD MTC states that a:

> Payment cannot be said to be 'for the use of, or the right to use' of a design, model or plan if the payment is for the actual development of a design, model or plan that does not already exist.

Provision of exclusivity

Paragraph 8.5 to the commentary of Article 12 of the OECD MTC indicate that where the payment is a compensation to secure exclusivity to the right of use of that property, such payment will form part of 'royalties' as defined. This is the case where the owner of that information or property agrees not to supply or grant to anyone else that information or right. These payments are said to be payments of "any kind received as consideration" for the information or property.

Industrial, Commercial and Scientific equipment

The commentary on Article 12 of the OECD MTC provides further that payments for the use of industrial, commercial and scientific equipment are not considered 'royalties' as defined. Effectively, the commentary indicates that because such leasing agreements do not generally incorporate a situation where there is no secret process being transferred to the lessor, such payments are not intended to be for use or right of use of the property as envisaged by Article 12. They are rather payments for services provided by the lessor. An example given is that of payments made by a telecommunication network operator to another operator under a typical roaming agreement. These payments will not constitute royalties under the Article 12 since these payments are not consideration for the use of, or right to use, property, or for information since there is no secret technology that is being used or transferred to the operator.

3.4.1 RIGHT OF USE - COMPUTER SOFTWARE

One of the important purposes of international tax principles is to facilitate international trade and investment. In a growing economy like South Africa, foreign investment is an important consideration in many economic decisions taken. The use of technology is fast becoming an important consideration for every entity. Therefore, entities find themselves in situations where a lot of reliance is placed on computer software developed by foreign entities, whether as a parent entity or as an unrelated party. For this access, a taxpayer may make a payment consideration for such computer software.

The commentary to Article 12 of the OECD MTC summarizes the complexities with regard to the treatment of payments for the use of software with the following comments: "Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms".

These factors may make it difficult to determine where the boundary lies on payments that are technically payments for ‘use of or right of use’ of property, payment for a service or payment for the disposition of full ownership rights. Furthermore, the ease of reproduction of computer software brings further complexities in determining exactly what the payment is for.

The nature of each payment for computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of that program. Therefore, each case will need to be analyzed in detailed based on the facts of that case. The commentary to Article 12 of the OECD MTC indicate that through its research into the treatment of software by each of its Member States, the OECD found that generally, the rights under computer programs are protected under copyright law. Similarly, computer programs are protected under the Copyright Act in South Africa. The commentary to Article 12 of the OECD MTC further indicates that the OECD found that although the term ‘computer software’ is commonly used to describe both the program and the medium on which the computer software is embodied, the copyright law of most OECD member countries recognises a distinction between the copyright in the program and software that incorporates a copy of the copyrighted program.

The commentary to Article 12 of the OECD MTC provides for the following rights that are generally transferred in computer software consists of the following rights:

- rights in the underlying copyright; or
- rights in a copy of the program.

Rights in the underlying copyright

The commentary to Article 12 of the OECD MTC indicates that where the payment is a consideration for the granting of rights to use the program in a way that would constitute an infringement of copyright if such license was not in place, such payment would qualify as ‘royalties’ as that would represent the ‘right of use’ of that program. Examples provided in the commentary includes arrangements such as licenses to reproduce and distribute to the

general public software that incorporates the underlying copyrighted program. This is because the payments represent compensation for utilizing the rights that would otherwise be the sole prerogative of the holder of the underlying copyrighter.

The commentary to Article 12 indicate that a payment for the transfer of rights that represent a noticeable and specific property will most likely not be a payment for the 'use of or right of use' of property. This is more likely to be the case with geographically-limited than time limited rights. Such transfer of rights results in the alienation of the transferor's ownership rights in that territory. For non-resident transferors, it is indicated that such transactions are covered under Article 7 of the OECD MTC as business profits and will be subject to normal South African tax to the extent that such a disposal is attributable to a permanent establishment of that non-resident in South Africa.

Rights in a copy of the program

The commentary to the OECD MTC indicates that where the payment is a consideration for the rights in a copy of the program, such payments are not considered 'royalties' for purposes of Article 12. Such cases are such that the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program. The rights transferred in these cases allow the user to copy/reproduce the program.

It is therefore important to understand the copyrights laws of each country involved in each case. The commentary to Article 12 of the OECD MTC indicates that in some countries, the act of copying the software program to another medium would result in a breach of copyright if the user does not have a licence and therefore such transfer of rights would therefore constitute a 'royalty' payment as indicated above. The commentary further highlights that the following:

> copyright laws of many countries automatically grant this right to the owner of software, which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive is an essential step in utilizing the program.

It is therefore important that the South Africa payer of the consideration to a non-resident transferor analyze the actual rights afforded under the agreement in relation to the laws of South Africa. In order for a non-resident to enjoy the protection afforded by the Copyright Act, such Copyright will need to be registered in South Africa.

Below is a summary of some of the Copyright Act provisions in South Africa with respect to computer programs.

Section 11B of the Copyright Act states that a copyright in a computer program vests the exclusive right to do or authorize the doing of any of the certain acts in the Republic including the reproduction of the computer program or letting, or offering or exposing for hire a copy of the computer program.

It therefore arises (based on the OECD principles discussed above) that if a South Africa resident performs any of the specified acts under section 11B, and the right of use agreement states that such acts will not be considered a contravention of the copyright awarded to them under the computer software right agreement, then such payment will qualify as royalty as defined unless it relates to any act of the nature as indicated in section 19B below.

Section 19B of the Copyright Act provides that:

> a copyright in a computer program shall not be infringed by a person who is in lawful possession of that computer program, or an authorized copy thereof, if—
> (*a*) he makes copies thereof to the extent reasonably necessary for back-up purposes;
> (*b*) a copy so made is intended exclusively for personal or private purposes; and
> (*c*) such copy is destroyed when the possession of the computer program in question, or authorized copy thereof, ceases to be lawful.

Section 19B of the Copyright Act aligns with the commentary of OECD in that it will not be infringement of a copyright if the copying of the software is just a form of enabling the user to operate such a program.

For a copyright protected by the Copyright Act, the payment of software licences will only be royalty as defined if the payer has been licenced the copyright in terms of the Copyright

Act. This is because such a licence provides a right of use of the copyright and not just a mere use of the software.

Another important factor noted in the OECD commentary on Article 12 is that restrictions on the use of the computer software by the transferee does not preclude the transfer to be an alienation of rights. Such an agreement would still qualify as a transfer of rights in a copy of a program and not qualify as part of 'royalties'.

In certain instances, the transferee obtains rights to make multiplies copies of the computer program (e.g. to other subsidiary companies or other employees) and any other form of reproduction is prohibited. Paragraph 14.2 of the commentary on Article 12 indicates that such payments will generally be dealt as business profits under Article 7 of the OECD MTC. Paragraph 14.4 of this commentary provides an example of an arrangement between a software copyright holder and a distribution intermediary where the copyright holder will provide to the distribution intermediary the rights to distribute copies of the software program without the giving away the right to reproduce that program. It provides that the rights obtained in relation to the copyright are limited to those necessary for the intermediary to distribute copies of the computer program. Therefore, the intermediary distributor is only paying for the cost of acquiring copies of the software and not the right to utilize any right of use in the software copyrights. Therefore, payments of such nature under such arrangements will not qualify as 'royalties' as defined.

Mixed Contracts – Computer Software

The OECD acknowledges the issues faced by taxpayers in practice in determining whether a contract is for right of use of the underlying copyright, right in a copy of the program or is the payment is for provision of services. Paragraph 17 of the Commentary on Article 12 indicates that were necessary, the payment under the contract should be broken down into its separate components on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

Paragraph 17.3 of the commentary on Article 12 states that payments for transactions that permit the customer to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment are essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services).

The commentary to Article 12 states that in these transactions, the payment is basically for the acquisition of data that is transmitted through digital signal and therefore would not constitute royalties. To the extent that the act of copying the digital signal onto a non-temporary media involves the use of a copyright under that country's law and contractual arrangements, such copying is simply a means by which that digital signal is captured and stored. The commentary indicates that:

> This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as 'royalties' if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

This transaction classification is distinguished in the OECD commentary on Article 12 with a transaction where the payment is essentially for the granting of the right to use a copyright in a digital product that is electronically downloaded. Such a payment will be considered 'royalty' as defined. Paragraph 17.4 of the commentary on Article 12 provides that this would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, that is, the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.

3.5 IMPARTING OF KNOW-HOW

The second part of the definition of 'royalty' for purposes of Part IVA of the Act relates to payments for:

> the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information.

This concept is widely referred to as 'know-how'. The Act does not define or provide guidance on the nature of payments that would be considered to be consideration for the imparting or undertaking to impart, the rendering or the undertaking to render such knowledge or information as envisaged by the section 49A of the Act. The draft Interpretation Note on withholding taxes on royalty also does not provide much guidance in this regard.

The draft Interpretation Note on withholding taxes on royalty defines the term 'Impart', 'Knowledge' and 'Information' by making reference to the Oxford dictionary meaning. The meaning ascribed to these words are shown below.

'Impart': *Make (information) known.*[10]
The draft Interpretation Note indicates that "a payment received by or accrued to a person for imparting (for example through instruction or teaching) scientific, technical, industrial or commercial knowledge or information will be considered a royalty".

One would need to consider the other factors that need to be met before one can conclude that this is subject to withholding taxes on royalties for purposes of Part IVA of the Act.

'Knowledge': Facts, information, and skills acquired through experience or education; the theoretical or practical understanding of a subject.[11]

[10] https://en.oxforddictionaries.com/definition/impart (Accessed on 07 March 2018)
[11] https://en.oxforddictionaries.com/definition/knowledge (Accessed on 07 March 2018)

'Information': Facts provided or learned about something or someone[12]

Furthermore, the word 'rendering' is used in the above royalty definition. The Oxford dictionary defines the words as: "The action of giving or surrendering something"[13]

It follows that included in the definition of royalty for purposes of Part IVA of the Act is any payment for the action of giving or surrendering any assistance or service in connection with scientific, technical, industrial or commercial facts, information, and skills acquired through experience or education.

In addition, the researcher has reviewed certain court cases that provide guidance on the nature of what has previously been considered or referred to as know-how. Furthermore, guidance is sort from the OECD MTC as similar concepts are used in the OECD double tax agreements.

Cases dealing with know-how

Moriarty (Inspector of Taxes) v Evans Medical Supplies Ltd Case

In the case of *Moriarty (Inspector of Taxes) v Evans Medical Supplies Ltd* (1957), certain principles relating to know-how were explained that the researcher is of the view are of relevance if not of importance to the understanding of this concept. The case involved whether a payment (£100 000) of a lump sum for imparting secret process relating to the manufacture of pharmaceutical products and for furnishing plans, technical data, drawings for the erection of a factory and installation of machinery suitable for the manufacture of pharmaceutical and other products in Burma is taxable.

The Inspector of Taxes had included the full amount of £100 000 as normal income subject to tax. The taxpayer, being Evans Medical Supplies Ltd (Evans), contended that such receipt was capital in nature and thus not subject to normal tax in Burma. Lord Viscount S held that

[12] https://en.oxforddictionaries.com/definition/information (Accessed on 07 March 2018)
[13] https://en.oxforddictionaries.com/definition/rendering (Accessed on 07 March 2018)

the court (by majority) was of the view that the full amount was of capital nature. The court indicated that the imparting of the secret process and the other services in that contract were indivisible and thus the whole amount was of capital nature as a particular market that was available to the taxpayer had now been lost/diminished.

Lord Denning had a dissenting view, which the researcher finds to be of relevance to the understanding of 'know-how'. The principle noted from Lord Denning's dissenting view was that 'know-how' cannot be sold outright but rather can be used to make things for sale or teach it to others for a reward. The supplier of know-how will always be entitled to use it himself.

For purposes of the South African withholding taxes on royalty provisions, it is important to note that such know-how should be related to scientific, technical, industrial or commercial knowledge or information.

In ITC 1190 (1970), the court cited Lord Denning's speech from the *Musker v English Electric Co Ltd* (1962) case and quoted the following :

> 'Manufacturing technique' is just know-how. Know-how is an intangible asset, just as intangible as goodwill and just as worthy of recognition. It is revenue-producing asset, just as goodwill is. Know-how can be put to use so as to produce revenue in two ways. The manufacturer can use it himself to make things for sale and make profit in that way; or he can teach it to others, so that they can make their own things, in which case he gets paid for the knowledge and information which he imparts to them.

***Rolls-Royce Ltd v Jeffrey* (Inspector of Taxes) Case**

The *Rolls-Royce Ltd v Jeffrey (Inspector of Taxes)* (1962*)* case dealt with a similar concept. This case illustrates to the reader the nature of payments that have previously been considered 'know-how'.

This case is distinguished from that of *Moriarty (Inspector of Taxes) v Evans Medical Supplies Ltd* above. Royce-Rolls, being a manufacturer of aero engines entered into a series

of agreements with Nationalist China, France, the United States of America, Belgium, Sweden, the Argentine and Australia, under which they undertook to supply drawings and manufacturing and engineering data and information necessary to enable engines of a particular type to be manufactured. They further undertook to teach technicians from those countries and to send some of their own employees to supervise operations there, and also to communicate, so far as they were permitted to do so, future improvements and developments.

Payments to be made to the manufacturers under the agreements include lump sums and royalties. The royalties were payable on engines and parts of engines manufactured, and the lump sums were described as "consideration for the rights granted" and referred to as capital sums. It appeared that the manufacturers could not hope to sell their engines in those countries and therefore pursued a policy of allowing local manufacture, for otherwise they would have got nothing from those countries. The court had to determine whether the ‘lump sums’ received under the agreements were income or capital receipts in the hands of the manufacturer.

In concluding that the lump sums where income in nature, Lord Reid stated that had they not made these agreements they would have got nothing from these countries. By making them they were able to exploit their capital asset by receiving large sums for its use in those countries. In essence, what they did was to teach the ‘licensee’ how to make use of the ‘licenses’ which they granted.

In the same case, Lord Radcliffe noted the following with regard to ‘know-how’: “ ‘know-how’ has the peculiar quality that it can be communicated to or shared with others outside the manufacturer's own business, without in any sense destroying its value to him”

OECD MTC Guidance: Know-how

As previously noted, the commentary of the OECD MTC has a persuasive nature in the interpretation of double tax agreements entered into by South Africa.

In terms of the definition of ‘royalties’ as per Article 12 of the OECD MTC, royalty includes payments of any kind received as consideration for information concerning industrial, commercial or scientific experience. This definition is similar to the ‘know-how’ provision of the definition of ‘royalty’ for purposes of Part IVA of the Act. Therefore, the researcher intends to take into account the interpretation of the Article 12 definition as outlined in the OECD MTC commentary into account in the interpretation of the ‘know-how’ provision in terms of Part IVA of the Act.

Paragraph 11 of the commentary to Article 12 of the OECD MTC states that in classifying as royalty payments received as consideration for information concerning industrial, commercial or scientific experience, Article 12 is refers also to the concept of ‘know-how’. Paragraph 11 of the commentary on Article 12 further indicates that reference to “information concerning industrial, commercial or scientific experience” is used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. The know-how in question generally relates to undivulged information of the nature covered by Article 12 arising from previous experience, which has practical application and relevance in the operation of an enterprise and from the disclosure could result in an economic benefit. As the classification relates to information concerning previous experience, it is indicated that the Article would not be applicable to payments for new information obtained as a result of performing services requested by the payer. Such payment are not royalty payments as defined but rather payments for services rendered.

Paragraph 11.1 of the commentary to Article 12 states that the grantor is niether required to play any part himself in the application of the formulas granted to the licensee nor does he guarantee the result thereof. Paragraph 11.2 of the commentary to the Article 12 describes a contract for the provision of a service as one where the parties undertakes to use the customary skills of his calling to execute work himself for the other party.

The OECD acknowledges the difficulty encountered in distinguishing this two types of payments being payments for royalty and payment for services. Guidance is provided by the OECD in the commentary to Article 12 of the OECD MTC. The following criteria is provided which is relevant for the purpose of differentiating a royalty payment from a payment for provision of services.

- Contracts for the supply of know-how concern information of the kind described in paragraph 11 [as discussed above] that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.
- In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise *but not the transfer* of such special knowledge, skill or expertise to the other party. (own emphasis)
- In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

It is important to note that the OECD MTC includes know-how in relation to information concerning industrial, commercial or scientific experience. The domestic definition of royalty for purposes of the withholding tax on royalty in South Africa includes know-how in relation to technical information or knowledge in addition to the industrial, commercial and scientific information or knowledge. This discrepancy is discussed in more detail in Chapter 4 below.

The researcher is of the view that the OECD commentary guidance should be used as an important guide in the interpretation of what would qualify as “imparting or undertaking to impart technical knowledge/information” or “the rendering or undertaking to render assistance or service in connection with the application or utilization of technical knowledge or information”.

Based on the principles established above from the OECD commentary, the researcher is of the view that a payment for imparting of technical knowledge or information will qualify as a royalty payment if:

- The supply of such know-how is for existing technical knowledge or information that cannot be shared with any third party without the authorization of the supplier providing such information or knowledge of technical nature;
- The supplier transfers the specialized technical knowledge or information to the other party without diminishing the value of that technical knowledge or information to the himself; and
- In providing such knowledge or information to the other party, the supplier incurs little or no additional costs in relation to that technical knowledge or information as the information provided will be existing knowledge or information and not one to still be established or created.

Brincker (2017), in his article featured in MNE Tax Journal[14], commented on the draft Interpretation Note on withholding taxes on royalties that was issued by SARS. Brincker noted the following:

> In the draft Interpretation Note, it is indicated that an amount will also be regarded as a royalty if it is received by or accrued to a person who provides or agrees to provide any assistance or service relating to the application or use of the knowledge or information. An amount will thus be a royalty if it is received in return for showing the user of intellectual property how to put the knowledge or information to use or if received by a person with industrial knowledge in exchange for demonstrating how to use an invention in an industrial project.

Know-how: Computer Software

Paragraph 11.5 of the commentary on Article 12 describes a payment for know-how in relation to software as one where it is for the acquisition of information constituting ideas and principles underlying the program. And such information is provided under the condition that the customer does not disclose it without authorisation and where it is subject to any available trade secret protection. The researcher is of the view that a payment for know-how in relation to computer software will qualify as know-how for royalty purposes if it relate to the licensor transferring know-how to the licensee relating to the underlying copyright. The researcher is of the view that if such information is provided to the licensee with no limitation

[14] https://mnetax.com/south-africa-issues-draft-guidance-withholding-tax-royalties-20030 (Accessed on 01 March 2018)

on the disclosure to others of such information, then the value to the licensor would have diminished. As a result, the payment would be consideration for the alienation of a right and thus capital in nature regardless of the form of payment (instalment or lump sum).

The researcher notes the difficulty in determining the actual nature of certain transactions as to whether they are 'royalty' as defined or not. This research report aims to provide guidance by providing the underlying principles arising from the review of literature and the commentary on Article 12 as issued by the OECD. The conclusions reached by the researcher are based on the underlying facts surrounding that particular discussion. It is therefore imperative that each case is analysed in detailed based on its own facts and decided on its own merits taking into account the principles outlined above.

CHAPTER 4: OTHER TAX CONSIDERATIONS ON WHT ON ROYALTIES

4.1 DUE AND PAYABLE

Timing as to when withholding tax on royalty is to be levied is an important consideration in the levying and payment of withholding tax on royalty. Once a South African taxpayer has determined that the a consideration that qualifies as royalty payment is to be made to a foreign person, the next step it to determine when is the consideration deemed to be paid in terms of the Act.

Section 49F(1) of the Act indicates the following with regard to when the withholding tax withheld by the resident is to be paid over to SARS:

> If, in terms of section 49C, a foreign person is liable for any amount of withholding tax on royalties in respect of any amount of royalties that is *paid* to or for the benefit of the foreign person, that foreign person must pay that amount of withholding tax by the last day of the month following the month during which the royalty is *paid*, unless the tax has been paid by any other person. (own emphasis)

From the above, it is clear that the date the royalty payment is deemed to be paid, is an important consideration as it will determine the correct timing for the submission of the relevant tax return and the payment of the withholding tax withheld by the resident to SARS.

Section 49B(2) of the Act indicates that a royalty is deemed to be paid on the earlier of the date on which the royalty is paid or becomes due and payable. It is simple to determine the date of payment but in some instances, the amount is due and payable earlier that the date of payment. With the reporting obligation on submission of the return and the payment being the following month of the month the royalty is paid (earlier of payment or due and payable), it is important to ensure that the royalty consideration is not due and payable much earlier than payment as the non-submission of the relevant returns and payment will result in non-compliance with tax laws.

The research is of the view that this could result in the disruption of operations where a tax clearance certificate is sought after by supplier or customers as this will result in a tax clearance certificate reflecting ‘non-compliance’ by the payer. It may however be difficult

for SARS to determine whether a South African taxpayer is non-compliant with these provisions until such time that the taxpayer submit the relevant returns, the ultimate costs for non-compliance will be in the form of penalties and interest for late payment and submission of the returns.

The words 'paid' and 'due and payable' are discussed in detail by SARS in the Comprehensive Guide to Dividends Tax (2017: 59)[15]. The Comprehensive guide indicates the following in relation to dividends declared: "A delay may exist between –

- the due date and the date on which the dividend is payable; and
- the date the dividend is payable and the date of actual payment of the dividend."

Paid

"An amount can be paid in a variety of ways, including in cash, in kind, in the form of set-off or by crediting a loan account. There is generally little difficulty in determining the date of payment when the dividend is paid in cash. However, the date of payment can be more difficult to establish when payment is in a form other than cash."
(Comprehensive Guide on Dividends Tax, 2017)

In ITC 1688, the court held that payments in a form other than cash, cheque or set-off can discharge a debt only with the creditors consent [16]. It was noted, based on the facts of the case, that this took place when the respective resolutions were passed and not when the physical crediting of the loan account took place. The Judge however highlighted the following:

> I should emphasise finally that nothing I have said should be understood to mean that where declared dividends are left on loan in a company, it will be presumed or will necessarily mean that payment takes place at the time the dividend is declared. At the risk of repeating myself I stress that the date of payment is a question of fact, and that as such the date must be determined on the particular facts of each case.

Due and Payable

In *Singh v Commissioner of SARS* (2003), Olivier JA indicated the following:

> The ordinary meaning of 'due' is that '. . . there must be a liquidated money obligation presently claimable by the creditor for which an action could presently be brought against the debtor. Stated

[15] Comprehensive Guide to Dividends Tax (Issue 2) dated 12 October 2017 in paragraph 3.2.1.
[16] Cited from the Comprehensive Guide on Dividends tax (Issue 2) dated 12 October 2017.

> another way, the debt must be one in respect of which the debtor is under an obligation to pay immediately….. The word 'payable' can have at least two different meanings, viz '. . . (a) that which is due or must be paid, or (b) that which may be paid or may have to be paid. . . . The sense of (a) is a present liability due and payable . . . (b) . . . a future or contingent liability.

In *Stafford v Registrar of Deeds* (1913), Searle J. indicated that the word 'payable' is sometimes construed as meaning 'payable at a future time,' or 'in respect of which there is liability to pay'.

The Comprehensive Guide on Dividends tax provides clarity by stating that for an amount to be 'due and payable', the amount must not only be owing to a person, but a person must have the right to claim payment of it.

4.2 EXEMPTIONS

Section 49D(1) of the Act provides an exemption to a foreign person from the withholding tax on royalties if—

(a) that foreign person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the royalty is paid; or
(b) the property in respect of which that royalty is paid is effectively connected with a permanent establishment of that foreign person in the Republic if that foreign person is registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act; or
(c) that royalty is paid by a headquarter company[17] in respect of the granting of the use or right of use of or permission to use intellectual property as defined in section 23I to which section 31 does not apply as a result of the exclusions contained in section 31(5)(c) or (d).

4.2.1 EFFECTIVELY CONNECTED WITH A PERMANENT ESTABLISHMENT

Section 49D(1)(b) above indicates that a foreign person will be exempt from withholding tax if the amount being paid is effectively connected with a permanent establishment (PE) of that foreign person in South Africa.

[17] Section 1 of the Act "headquarter company", in respect of any year of assessment means a company contemplated in section 9I (1) in respect of which an election has been made in terms of that section;

The concept of PE is a complex subject matter in the field of international tax and double tax agreements. In the South African domestic law, a PE is defined in section 1 of the Act as follows:

> **"permanent establishment"** means a permanent establishment as defined from time to time in Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development: Provided that in determining whether a qualifying investor in relation to a partnership, trust or foreign partnership has a permanent establishment in the Republic, any act of that partnership, trust or foreign partnership in respect of any financial instrument must not be ascribed to that qualifying investor;

Article 5 of the OECD MTC defines PE as "a fixed place of business through which the business of an enterprise is wholly or partly carried on". Paragraph 2 of Article 5 provides that:

> 'permanent establishment' includes especially:
> a) a place of management;
> b) a branch;
> c) an office;
> d) a factory;
> e) a workshop, and
> f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

Paragraph 3 of Article 5 further provides that "a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months".

In ITC 1878 (2015), the court emphasized the need to interpret international treaties in a manner which gives effect to the purpose of the treaty and which is congruent with the words employed in the treaty. This case dealt with a situation where the taxpayer was of the view that in order to have a permanent establishment, the taxpayer had to carry on a business through a fixed place even if one is caught by one of the provisions of paragraph 2 of the Article 5. The treaty in question was the United States of America and South Africa's double tax agreement.

In this case, the Commissioner of SARS was of the view that the word 'includes' is intended to include those activities in paragraph 2 of Article 5 and that such activities need not be carried through a fixed place of business. Vally J indicated that:

> the word 'include' used in a statute is often used to extend or enlarge the meaning of a thing or concept. It brings within the scope of the thing or concept others that are not ordinarily or naturally part of the thing or concept.

Vally J continued with the speech and indicated that

> If this is so then it has to be inferred that by using the term or phrase 'includes especially', the drafters of the treaty intended that the factors referred to in article 5(2)(k) be made part of the definition referred to in article 5(1). They were particularly drawn towards making sure that those factors are given special attention when determining whether a particular business enterprise can be said to be operating through a 'permanent establishment' in a non-resident country within which it conducts business or provides services. Otherwise they would not have used the words 'includes especially'. It therefore has to be interpreted that the contents of article 5(2)(k) must be read to mean that they are an integral part of article 5(1). On this analysis, as soon as an enterprise's activities fall within the ambit of article 5(2)(k) it becomes liable for taxation in the non-resident country. There is no need for a further or separate enquiry as to whether the requirements of article 5(1) have been met. The two articles cannot be read disjunctively. The definition, by virtue of the bridging phrase 'includes especially', is a composite one. This clearly expresses the purpose of the treaty. To break it up and treat the two articles separately would be to ignore the natural and ordinary meaning of the phrase 'includes especially'.

Vally J noted that this interpretation is inconsistent with that adopted by the OECD commentary on the relationship between Article 5(1) and Article 5(2) of the OECD MTC which indicates that factors listed in Article 5(2) will only constitute a PE if they also meet the requirements of Article 5(1). This case highlights that each case must be analysed individually based on the facts and merits of that case.

The terms ‘effectively connected with such permanent establishment’ is referenced in Article 12(3). Potential abuses arise whereby the taxpayer transfers the rights or property to a PE set up in a country that offers preferential treatment to royalty income. The commentary to the Article 12(3) indicate that the term ‘effectively connected’ requires more than merely recording the right or property in the books of the establishment for accounting purposes in that location. The purposes is to counter-act such potential abuses.

Paragraph 21.1 of the commentary on Article 12 provides that a right or property in respect of which royalties are paid is ‘effectively connected’ with a permanent establishment, and therefore form part of its business assets, if the ‘economic’ ownership of that right or property is allocated to that permanent establishment.

The concept of 'economic' ownership of a right or property is the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens.

4.3 REDUCTION AT THE WITHHOLDING TAX RATE OF 15%

In terms of section 49E(3) of the Act, the WHT rate of 15% must be reduced if the foreign person to or for the benefit of which the payment is to be made has—

> (a) by a date determined by the person making the payment; or
> (b) if the person making the payment did not determine a date as contemplated in paragraph (a), by the date of the payment,
>
> submitted to the person making the payment a declaration in such form as may be prescribed by the Commissioner that the royalty is subject to that reduced rate of tax as a result of the application of an agreement for the avoidance of double taxation.

In the above-discussed ITC 1878 case, Vally J noted that "the purpose of Double Taxation Agreements is to ensure that there is a free flow of trade and investment across countries, as well as a recognition that taxation is not avoided by the latitude afforded by the flow of free trade and investment"

In order to apply the relevant treaties, the non-resident beneficial owner should ensure that the nature of the amount being paid is covered under the relevant Article of the treaty under which they are claiming a reduced rate.

Below the researcher discusses specific discrepancies in the definition of royalty as contemplated in section 49A of the Act and the definition contemplated in the OECD MTC. Such discrepancies can result in situation where a reduced rate relief cannot be claimed by the foreign person under Article 12 of the relevant DTA.

4.3.1 COMPUTER PROGRAM

In order to apply the provisions of Article 12 of the OECD MTC, the royalty payment must be for the use or right of use of any copyright of literary, artistic or scientific work. No special

mention is made in the OECD definition of royalty for computer program. Therefore, it order to claim relief, one would need to determine if a computer program could be considered 'scientific work' for purpose of the application of the DTA by the contracting states in the application of that DTA. Paragraph 13.1 of the commentary to Article 12 of the OECD MTC provides that:

> Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which either omits all references to the nature of the copyrights or refers specifically to software.

Such discrepancy and clarity is provided for in the definition of 'royalty' under the DTA between South Africa and United States of America. The researcher notes however that this specific DTA is not based on the OECD MTC but rather on the United States Model Income Tax Convention. The definition of 'royalty' for purposes of Article 12 of this DTA means:

> a) any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (*including computer software*, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trade mark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience; (own emphasis).

This treaty clearly stipulates that the computer software will be covered under it. Such mention provides clarity in the interpretation of treaties and thus aid in enhancing the purpose of the treaty.

Similarly, the DTA between South Africa and Japan, and that of South Africa and Sultanate of Oman also include a similar specific mention of software as part of the definition of royalties.

4.3.2 TECHNICAL KNOWLEDGE/INFORMATION

A major discrepancy between the definition of royalties under the OECD MTC and the South African domestic laws lies in the inclusion of imparting or undertaking to impart technical knowledge or information in the definition of 'royalty' for purposes of the levying of WHT on royalty in South Africa.

Therefore, unless specifically addressed in the DTA, a person will not be able to claim a reduced rate relief under a DTA where the WHT on royalty was subjected for the imparting or undertaking to impart technical knowledge or information, or for the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such technical knowledge or information.

An example of DTA that includes technical knowledge or information in addition to scientific, industrial and commercial knowledge or information in the Article dealing with royalties is that of South Africa and Australia. Therefore, a beneficial owner who is resident in Australia would be able to claim reduced rate relief (from 15% to 10%) under the DTA for payments relating to the know-how related to technical knowledge or information. Similar inclusion of technical knowledge or information is seen in the DTA between South Africa and Indonesia.

It is also important to differentiate the nature of payments of technical knowledge or information from payments for provision of services of technical nature. The DTA between South Africa and India provides relief for tax on royalties in Article 12 titled 'Royalties and Fees for Technical Services'.

This Article defines 'royalty' as payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including cinematograph films and films, tapes or discs for radio or television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience. It is clear that know-how related to technical knowledge or information is not envisaged in this definition.

The words 'Fees for Technical Services' are defined in that Article as "payments of any kind received as a consideration for services of a managerial, technical or consultancy nature, including the provision of services by technical or other personnel, but does not include payments for services mentioned in Article 15".

The researcher's assessment highlights that the nature of costs that are considered to be 'royalty' for purposes of Part IVA of the Act are those costs related to the imparting of technical knowledge and not for provision of services. Therefore, guidance outlined in Chapter 3 above should be used to determine whether the payment is 'know-how' for purposes of 'royalty' as defined in Part IVA of the Act or if it is for provision of a service.

4.3.3 ARM'S LENGTH ROYALTY AMOUNT UNDER DTAs

Paragraph 4 of Article 12 of the OECD MTC provides that the reliance on the Article will only be applicable to the extent that the royalty amount in question is arm's length.

The commentary to the OECD MTC on paragraph 4 of Article 12 indicates that "the paragraph permits only the adjustment of the amount of royalties and not the reclassification of the royalties in such a way as to give it a different character, e.g. a contribution to equity capital."

As most of the South Africa treaties are based on the OECD MTC, the arm's length principle is incorporated into the provisions of the treaties signed. The effect of this is that a foreign person can only claim relief under the treaty to the extent that the amount is arms' length. The excess will be subject to withholding tax at 15% in South Africa.

CHAPTER 5: BACKGROUND ON EXCHANGE CONTROL IN SOUTH AFRICA

The remaining chapters of this research report deal with the exchange control regulations that South African residents need to comply with when making royalty payments to foreign persons. The discussion starts with the history and background on exchange control in South Africa. Thereafter, the institutional arrangements with regard to exchange control in South Africa are outlined. Lastly, the regulations applicable to specific royalty transactions in South Africa are discussed

Exchange control was first introduced in South Africa at the outbreak of the Second World War in 1939. In the Constitutional Court case of South African Reserve Bank (SARB) *v Shuttleworth* (2015), Moseneke DCJ indicated that although South Africa was a developing country during the Second World War outbreak, which it still is, it was not shielded from a deep recession. The currency and economic conditions were on a downward slope during that time. As a counter measure against fears of a diminished direct investment and capital flight, the South African government put measures in place to prevent the total economic collapse of the country. As result, in 1933 parliament passed the Currency and Exchanges Act 9 of 1933 (The Currency and Exchange Act).

The Constitution of the Republic of South Africa[18] (the Constitution) indicate that the Reserve Bank is the central bank of the Republic whose primary purpose is to protect the value of the currency in the interest of balanced and sustainable economic growth in the Republic. In the Constitutional Court case of *SARB v Shuttleworth* (2015), Mosekene DCJ highlighted that fact and that the Constitution provides for an express mandate for protecting the value of the currency demonstrates the exceptional significance of the issue.

As noted on the South African Reserve Bank website[19], the central bank is responsible for contributing towards the achievement and maintenance of a stable financial system.

[18] Constitution of the Republic of South Africa Amendment Act, No. 3 of 1999
[19] https://www.resbank.co.za/Financial%20Stability/Pages/Rationale-for-a-financial-stability-focus.aspx (Accessed on 05 September 2017)

The Exchange Control Manual issued by the Financial Surveillance Department of the South African Reserve Bank provides a brief historical background leading into the relaxation of exchange controls in South Africa. The Exchange Control Manual provides the following flow of events:

> During July-August 1985 political developments and foreign reactions thereto, coupled with the withdrawal or non-renewal of credit lines extended by a number of foreign banks to South African banks or their clients, caused severe downward pressure on the exchange rate of the Rand. As a step along the indicated path of gradually abolishing exchange control, all such controls over non-residents were abolished by the termination on 13 March 1995 of the dual exchange rate system resulting in the disappearance of the Financial Rand.

Van der Merwe EJ (1996:11) noted some of the inherent drawbacks of exchange control in South Africa. The factors were noted are as follows:

- that exchange control hampers the effective application of monetary policy;
- deters inward foreign investment;
- is an economically inefficient way of rationing the available foreign exchange amongst the various users;
- has significant direct costs; and
- in a world economy characterized increasingly by globalization it has become extremely difficult to apply exchange control measures effectively

The government has since rapidly relaxed the exchange control regulations. In the 2014 Budget speech, the then Minister of Finance, Pravin Gordan announced that "The next phase of growth is about the dynamism and agility of the private sector and the synergies created with government. Government will continue to provide an enabling environment for businesses to grow and create employment". The Minister further indicated that government supported businesses in past recent years by relaxing exchange control regulations to support those who wanted to invest in the African continent. The Minister stated that this effort has to be scaled up to make a bigger impact on growth, jobs and development. This announcement served as a basis for the rapid relaxation of exchange control in South Africa.

Following the announcement by the Minister of Finance in the 2014 budget speech, the SARB embarked on a project to streamline the Exchange control rulings and Exchange Control Manual.

In July 2016, the Financial Surveillance Department (FinSurv) of the SARB, through an announcement in the Exchange Control Circular No 7/2016, indicated that the Exchange Control Rulings were withdrawn and replaced with 'the Currency and Exchange Manual for Authorised Dealers' and 'The Currency and Exchange Manual for Authorised Dealers in Foreign Currency with Limited Authority'. The Exchange Control Manual was also withdrawn and replaced with two guidelines documents namely 'the Currency and Exchange guidelines for Individuals' and 'the Currency and Exchange guidelines for business entities'.

In February 2017, FinSurv through an announcement in the Exchange Control Circular No 5/2017, communicated that companies and individuals no longer need the SARB's approval for standard intellectual property transactions. The "loop structure[20]" restrictions for all intellectual property transactions were also lifted provided they are arms' length and at a fair market price.

In terms of Regulation 2 of the Exchange Control Regulations, 1961[21] the general rule regarding payments outside the country (e.g. royalties) is that 'Authorised Dealers'[22] may sell foreign currency only for permissible purposes and on such conditions as the Treasury may determine. Persons or organisations purchasing exchange must state accurately the purpose for which the foreign currency is required and supply any additional information the Authorised Dealers may request in connection with the transaction concerned. The Currency

[20] Loop structure restrictions prohibit residents from holding any South African asset indirectly through a non-resident entity (Exchange Control Circular No. 5/2017 issued by the Financial Surveillance Department of the SARB)

[21] As promulgated by Government Notice R.1111 of 1 December 1961 and amended by Government Notice R.445 in Government Gazzete No 35430 of 8 June 2012.

[22] Means, in relation to any transaction in respect of gold, a person authorised by the Financial Surveillance Department to deal in gold and, in relation to any transaction in respect of foreign exchange, a person authorised by the Financial Surveillance Department to deal in foreign exchange.

and Exchange guidelines for business entities provides specific requirements that need to be adhered by business entities when making royalty payment to non-residents.

CHAPTER 6: INSTITUTIONAL ARRANGEMENTS ON EXCHANGE CONROL

Ultimately, the founding basis for the administration of exchange control lies in section 22 of the Constitution of South Africa. The Constitution of the Republic of South Africa vests national legislative authority in the hands of parliament. The parliament of South Africa is comprised of the National assembly and the National Council of provinces.

Section 9(1) of the Currency and Exchange Act empowers the President of the Republic to make regulations on any matter directly or indirectly affecting or related to currency, banking or exchanges. The President has in turn appointed the Minister of Finance to act on his behalf in carrying out this mandate. The President has, in terms of section 9 of the Currency and Exchange Act, made Exchange Control Regulations. Orders and Rules are furthermore made under the Regulations. Regulation 22E provides that "the Minister of Finance may delegate to any person any power or function conferred upon the Treasury by any provision of these regulations or assign to any such person a duty imposed thereunder to the Treasury."

As result, the Minister has appointed the SARB to carry out all the powers and functions assigned to the Treasury by the Currency and Exchange Act regulations except for the powers and functions assigned to the Treasury by regulation 3(5) and (8), 16, 20 and 22. In terms of paragraph 2 of the Orders and Rules as published[23], SARB was appointed by Treasury.

The Minister of Finance has also, in terms of Regulation 22E, delegated to the General Manager of the FinSurv, the Deputy General Manager and the Assistant General Manager of the FinSurv and/or any officer of the Reserve Bank, who in terms of the internal rules and regulations of exchange control is an authorised signatory of the FinSurv, all the powers, functions and duties assigned to and imposed on the Treasury under the Regulations with the exception of the powers, functions and duties assigned to and imposed on the Treasury by Regulations 16, 20 and 22 (which exceptions include the powers, duties and functions

[23] as published in Government Notice R1112 of 1 December 1961 and amended up to Government Notice 956 of 2016 in *Government Gazette* No. 40526 of 30 December 2016

contained in Regulations 22A(1)(a), 22A(1)(c), 22A(2), 22A(3), 22B, 22C(1), 22C(2)(b) and 22C(3) and 22D). (Exchange Control Manual, 2015)

Furthermore, paragraph 10(a) of the Orders and Rules indicates the following:

> Persons who desire information or advice on exchange or currency matters governed by the regulations or who require approval or permission in respect of exchange, currency or gold transactions so governed, should apply to the Exchange Control [SARB] through their bankers in the Republic or, if they have no such bankers, through one of the banks referred to in paragraph 3 hereof.

In terms of paragraph 3(a) of the Orders and Rules, 27 banks have been appointed as Authorised Dealers. A further 17 agents have been appointed as 'Authorised Dealers in foreign exchange with limited authority'[24] by the Minister. These banks have been appointed to assist the SARB with the administration of exchange control in South Africa. Only in cases where the dealer cannot approve the purchase or sale of the foreign currency in terms of the authority limitations, can the application be submitted to SARB through the head office of the Authorised Dealer. This policy has been termed the 'closed door policy'.

The 'closed door policy' has been challenged recently in court in the Supreme Court case of *Shuttleworth v SARB* (2015*).* Navsa ADP noted the decision of the high court with regard to the above matter and indicated that:

> In respect of the 'closed door policy', based on rule 10(a), made by the minister purportedly in terms of the Act, the high court held, first that there was legislative underpinning for the rule, and second that it was not unconstitutional. The high court accepted the justification supplied by the Reserve Bank, for applications to transfer assets out of the country to be processed through authorised dealers (banks), namely that it was a practical arrangement because the Reserve Bank's Exchange Control Department did not have the capacity to deal with the large number of applications and that authorized dealers acted within the parameters of exchange-control rulings and orders, and only when the rulings did not cater for a particular situation was it referred directly to the Reserve Bank.

Navsa ADP concluded and upheld the decision of the high court by indicating that there was force in the justification proffered by the Reserve Bank that it has limited resources and

[24] means an Authorised Dealer in foreign exchange with limited authority, as defined per the specific category that includes Bureaux de Change and Independent Money Transfer Operators, who are authorised by the Financial Surveillance Department to deal in foreign exchange transactions as determined by the Financial Surveillance Department. Currency and Exchanges guidelines for business entities (2017)

would not be able to deal with the flood of applications for the export of capital that occur on a regular basis.

The FinSurv within SARB therefore administers exchange control in South Africa including ensuring that exchange control is administered in the Common Monetary Area. The Common Monetary Area (CMA) consists of Lesotho, Namibia, South Africa and Swaziland. The CMA is governed by a multilateral monetary agreement which provides amongst other things, that there will be no restrictions on the transfer of funds, whether for current or for capital transactions in the CMA. (Van der Merwe. EJ. 1996:14)

The guidelines issued by the FinSurv indicate that they are intended to help the relevant parties by providing a general understanding of the exchange control system in South Africa. They do not have any legal ground and do not replace the Exchange Control Regulations (Regulations) promulgated in terms of section 9 of the Currency and Exchanges Act, 1933 (Act No. 9 of 1933).

CHAPTER 7: ANALYSIS OF EXCHANGE CONTROL REGULATIONS AFFECTING ROYALTY PAYMENTS

7.1 REGULATIONS ON ROYALTIES

Regulation 3 of the Exchange Control Regulations provides for the restriction on the export of currency, gold, securities, etc., and the import of South African bank notes. Specifically, regulation 3(1)(c) states the following:

> (1) Subject to any exemption which may be granted by the Treasury or a person authorized by the Treasury, no person shall, without permission granted by the Treasury or a person authorised by the Treasury and in accordance with such conditions as the Treasury or such authorised person may impose –
> ….
> (c) make any payment to, or in favour, or on behalf of a person resident outside the Republic, or place any sum to the credit of such person;

Furthermore, Regulation 2 provides that Authorised Dealers may only sell foreign currency for permissible purposes and on such conditions as the Treasury may determine. Therefore, in order for the banks to make a transfer of certain royalty payments to foreign persons, the bank have put in place certain documentary evidence requirements that they require before they can approval such a payment as agents of FinSurv.

Regulation 19 of the Exchange Control regulations indicate the following with regard to furnishing of information:

> (1) The Treasury, or any person authorised by the Treasury, may order any person to furnish any information at such person's disposal which the Treasury or such authorised person deems necessary for the purposes of these regulations and any person generally or specifically appointed by the Treasury for the purpose may enter the residential or business premises of a person so ordered and may inspect any books or documents belonging to, or under the control of such person.

The Minister of Finance has in turn assigned a similar power to the banks and published paragraph 3(b) of the Orders and Rules under the Exchange Control regulations. The order and rule provides that "(b) The Minister has, in terms of Regulation 19, also authorised the banks referred to in sub-paragraph (a) to order any person to furnish information required by them for the purposes of, and in connection with, their functions under the regulations."

Therefore, in order to carry their mandate of assisting the FinSurv with the administration of exchange control, the banks will request certain supporting information for the foreign currency payment. The information requested will depend on the nature of the payment being made.

In order to ensure an efficient administration of exchange control, FinSurv has issued certain Currency and Exchange guidelines. This report highlights only those Currency and Exchange guidelines for business entities that are of relevance to payments of royalty as defined to foreign persons. The guidelines provides an overview of those permissible transactions relating to foreign exchange that can be effected by Authorised Dealers without further approval from the FinSurv. Any reference below to guideline refers to the guidelines as laid down in the Currency and Exchange guidelines for business entities.

7.1.1. GUIDELINES - COMPUTER SOFTWARE.

Currency and Exchange guideline 6.4 provides that royalty payments to non-residents[25], including any licence fees that are payable from the local reproduction or copying of computer software packages may be effected provided that the licensor is an unrelated party and the application is accompanied by documentary evidence confirming the purpose and amount payable. Therefore, where the royalty payment relates to software and it is paid to a related party[26], approval will need to be obtained from the FinSurv through the Authorised Dealer. Furthermore, percentage-based fee payments are permissible provided that the resident payer confirms it is normal in the trade concerned. All documentation required under the guidelines must be retained by the business entity for a period of not less than 5 years.

[25] For purposes of the regulations, a Non-resident means a person (i.e. a natural person or legal entity) whose normal place of residence, domicile or registration is outside the CMA.
[26] A related party is defined as a party to a transaction that has a direct or indirect interest in the other party and has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions. (Currency and Exchanges guidelines for business entities. 2017:44)

7.1.2. GUIDELINES - ROYALTIES AND FEES BY SOUTH AFRICAN ENTITIES

Currency and Exchange guideline 10.7 provides that payments for services rendered by non-residents are transferable by the Authorised Dealer upon the business entity furnishing the Authorised Dealer with a copy of the agreements entered into or an invoice verifying the purpose of the payment and the amount payable. Where advance payments or down payments are required, such payments will be permissible to the extent that the advance payment or the down payment is recoupable against future royalties or fees payable by the resident business entity.

Furthermore, percentage-based fee payments are permissible if the resident payer confirms it is normal in the trade concerned. Where the business entity has made recurring payments in terms of a royalty agreement, the applicant entity is required to submit a letter to the Authorised Dealer in respect of the royalty payments, from an independent auditor, annually confirming the amount and percentage transferred over a 12-month period.

Where the payment is to be made to a related party, the applicant business entity is required to submit a suitable application to the FinsSurv through an Authorised Dealer.

7.1.3. *GUIDELINES - LICENCE AGREEMENTS INVOLVING THE LOCAL MANUFACTURE OF GOODS*

In terms of the Currency and Exchange guideline 10.8, royalties and fees payable to a non-resident (related and unrelated party) in respect of the licence agreements relating to the local manufacture of goods are permitted and can be effected by an Authorised Dealer subject to the following criteria:

- in respect of any new, renewed or amended licence agreement involving the local manufacture of goods, licensees must submit the royalty agreement in triplicate, supported by a statement furnishing the information called for in the questionnaire Form DTP 001 directly to the Technology Transfer (Royalties) Unit, Directorate of the Enterprise Organisation, Department of Trade and Industry, Private Bag X86, Pretoria, 0001 and not to the Financial Surveillance Department;
- the payments to be made must fall within the terms of the relative agreement and, where applicable, comply with any conditions laid down in the authority granted by the Department of Trade and Industry;

- where applicable, minimum payments, advance payments and down payments are permissible provided that the client confirms that such payments are normal in the trade concerned and the advance payments and down payments are recoupable from future royalties or fees payable;
- prior to any payments being effected, the licensee must present to an Authorised Dealer a copy of the approval letter granted by the Department of Trade and Industry together with an invoice from the licensor, verifying the purpose and the amount involved from the relevant non-resident party; and
- for recurring payments, a letter from the independent auditors of the local applicant entity, confirming the amount or percentage transferred or to be transferred has been correctly calculated and is reasonable in the trade concerned, must be submitted to the Authorised Dealer effecting the transfer at least once per calendar year.

7.1.4. GUIDELINES - TECHNICAL SERVICE PAYMENTS

For purposes of section 49A of the Act, royalties include amount paid for the imparting or the undertaking to impart technical knowledge or information. In certain instances, such amounts might be described as technical service fees but on detailed review, one can establish whether they qualify as 'royalty' as defined. In terms of the Currency and Exchange guideline 24 read with guideline 24.13 certain technical service fees can be remitted abroad by the Authorised Dealer against submission of documentary proof confirming the amounts involved. This fees envisaged by guideline 24.13 are those fees, including reimbursements of air fares to CMA countries, due in respect of non-residents brought to South Africa for the specific purpose of installing or repairing specialised machinery and equipment, or for commissioning and supervising the installation thereof, as well as training local personnel in this regard.

Therefore, for payments of such nature, the Authorised Dealer can remit the payment without further approval from the FinSurv.

7.2 CONTRAVENTION OF REGULATIONS

Regulation 22 of the Exchange Control regulations provides for a penalty for the non-compliance with the exchange control regulations. The regulation is summarized as follows:

Every person -

- who contravenes or fails to comply with any provision of these regulations, or contravenes or fails to comply with the terms of any notice, order, permission, exemption or condition made, conferred or imposed thereunder, or

- who obstructs any person in the execution of any power or function assigned to him by or under these regulations, or
- who makes any incorrect statement in any declaration made or return rendered for the purposes of these regulations (unless he proves that he did not know, and could not by the exercise of a reasonable degree of care have ascertained, that the statement was incorrect) or refuses or neglects to furnish any information which he is required to furnish under these regulations,

shall be guilty of an offence and liable upon conviction to a -

- fine not exceeding two hundred and fifty thousand rand or
- to imprisonment for a period not exceeding five years or to both such fine and such imprisonment;

provided that where he is convicted of an offence against any of these regulations in relation to any security, foreign currency, gold, bank note, cheque, postal order, bill, note, debt, payment or goods, the fine which may be imposed on him shall be a fine not exceeding two hundred and fifty thousand rand, or a sum equal to the value of the security, foreign currency, gold, bank note, postal order, bill, note, debt, payment or goods, whichever shall be greater.

As indicated in the chapter 7 on institutional arrangements on exchange control, regulation 22 of the Exchange Control regulations has not been delegated by the Minister of Finance to SARB. Therefore, the enforcement of this regulation vests with Treasury and will be enforced at that level should any person contravene the regulations.

It is important to note that the lack of prior approval of a foreign exchange control transaction does not necessarily make the transaction null and void for the convenience of any of the parties involved. A few cases over the years have been heard in court where one of the parties wanted to nullify a contract in an attempt to relieve themselves of their contractual obligations for which prior exchange control approval had not been obtained.

In the *Nestel v National And Grindlays Bank* (1962) case, Steyn CJ stated that "It is not within the scope or purpose of these regulations to provide any debtor with any facility so basically subversive of financial relations. Their object is to control foreign exchange in the public interest, not to grant a selective moratorium to a particular class of defaulting debtors."

In *Barclays National Bank Ltd v Thompson* (1985), Hoexter, JA indicated that the legislature could not have intended to subject litigants of the class with which we are concerned to such a sweeping disability unless such a conclusion is to be gathered clearly from the explicit language of regulation 3(1)(c) or the conclusion is inevitable as a matter of necessary and distinct implication. Hoexter, JA indicated that had the object behind regulation 3(1)(c) been to make legal proceedings an instrument for the enforcement of regulation 3(1)(c) by

requiring Treasury exemption or permission as a prerequisite to an action for the payment of money outside the Republic, the legislator would have framed the provisions of regulation in that manner as it was simple matter to do so. Furthermore, the court held that embodied in the regulations is a criminal sanction which is designed to enforce compliance and the penalty prescribed for non-compliance is a stiff one. Hoexter, JA also noted that nothing prevents Treasury from consenting to a transaction after the event.

In *Oilwell v Protec* (2011), Harms DP noted that the regulations are for public interest and not to protect any private interest. Harms DP stated that the regulations were adopted for the sake of The Treasury and not for the sake of disgruntled or disaffected parties to a contract. Harms DP held that the penalty provisions of the regulations provide that any money or goods in respect of which a contravention has been committed may be attached by The Treasury, may be forfeited to the State, and any shortfall may be recovered by The Treasury from not only persons involved in the commission of the offence but also from anyone enriched or who has benefited as a result thereof. Therefore, it has held that to add irremediable invalidity to the transaction would amount to overkill.

Harms DP however highlighted that the conclusion noted above do not mean that in the absence of approval from Treasury, that the transaction is always enforceable without more. Harms DP noted that both parties are obliged to take the necessary steps to obtain necessary consent from Treasury.

CHAPTER 8: CONCLUSION ON WITHHOLDING TAXES AND EXCHANGE CONTROL ON ROYALTIES

This research is a critical analysis of the South African tax and exchange control implications of royalty payments to non-residents. The main question arose due to the difficulty in the interpretation of the definition of royalty as defined in section 49A of the Act with respect to amounts accrued or received by foreign persons for the imparting or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information.

Furthermore, the research analyses the nature of payments for computer software that are technically for the use or right of use of that computer software and what really characterizes this kind of payments. Other tax consideration covered in this research includes a discussion of the concept of effectively connected with such a permanent establishment and some of the discrepancies between the domestic law and double tax agreements when a foreign person seeks to obtain relief for a reduction in the withholding tax rate. This chapter compiles the findings and recommendation on the withholding taxes and the applicable exchange control regulations on royalties.

South Africa imposes withholding taxes on royalties paid to foreign persons regardless of actual source through the deeming source provisions incorporated in the Act. It is difficult for tax authorities to collect income taxes chargeable on the earnings derived by non-residents from business carried out in the source country. WHT provisions are introduced in many tax systems across the world to facilitate the collection of taxes from non-residents and to limit the tax base erosion of that country. Part IVA of the Act provides for the withholding tax regime with regard to royalties paid to foreign persons and is applicable to royalty paid or that become due and payable on or after 1 July 2013.

To fully comprehend the scope of the intellectual property covered by Part IVA of the Act, the definition of intellectual property as provided for in section 23I is reviewed. Specifically,

the researcher noted that property of right of a similar nature encompasses such property or right that possess fundamental characteristics common to those possessed by the specifically identified properties and that minor or superficial similarities will not of themselves suffice.

The researcher performed a detail review of literature and the review of the OECD MTC and Commentary to Article 12 of the OECD MTC. The Commentary to Article 12 indicates that definition of royalty applies to payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been, or are required to be, registered in a public register. Furthermore, it was noted that payments for the full ownership of an element of a property does not constitute consideration for the use or right of use of property and therefore is not considered a royalty. It was noted that the essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or by the fact that the payments are related to a contingency.

To qualify as royalty, the OECD provides that the consideration must be for the use or right of use. Payments for the right of use of industrial, commercial and scientific equipment are also not expected to form part of royalty as such payments are not for the use or right of use envisaged by Article 12 as there is no secret technology that is being transferred to the payer of the amount.

The concept of right of use was expanded to computer software. It was noted that where the payment is a consideration for the granting of rights to use the software program in a manner that would, without such license, constitute an infringement of copyright, such payment would qualify as ‘royalties’. Where the payment is a consideration for the rights in a copy of the program, such payments will not qualify as royalty. The researcher recommends that each transaction should be analyzed on a case by case basis and a decision arrived on based on its own merits in relation to the copyright laws of the countries involved.

The main topic being know-how was addressed in Chapter 3.4. Lord Denning noted in the *Moriarty (Inspector of Taxes) v Evans Medical Supplies Ltd* case that know-how cannot be

sold outright but rather can be used to make things for sale or teach it to others for a reward. The supplier of know-how will always be entitled to use it himself. Lord Radcliffe shared the same view with Lord Denning with regard to the nature of know-how in that he is of the view that know-how has the peculiar quality that it can be communicated to or shared with others outside the manufacturer's own business, without in any sense destroying its value to holder/supplier.

The OECD commentary indicates that know-how is used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. It was also noted that the grantor of know-how does not have to be involved in the actual work as long as the formulas granted are of a specialized nature for which he has obtained through experience. Detailed guidance was provided from the Commentary on Article 12 which distinguishes a payment for know-how (which qualifies as royalty) against a payment for the provision of services. The underlying characteristics of a payment for imparting of know-how to qualify as a royalty payment are outlined as follows:

- The supply of such know-how is for existing industrial, technical, commercial or scientific knowledge or information that cannot be shared with any third party without the authorization of the supplier providing such information or knowledge;
- The supplier transfers the specialized industrial, technical, commercial or scientific knowledge or information to the other party without diminishing the value of that technical knowledge or information to the supplier; and
- In providing such knowledge or information to the other party, the supplier incurs little or no additional costs in relation to that technical knowledge or information as the information provided will be existing knowledge or information and not one to still be established or created.

With regard to know-how relating to computer software, the researcher is of the view that payments for know-how in relation to computer software will qualify as know-how for royalty purposes if it is paid to the licensor for transferring know-how to the licensee relating

to the underlying copyright. If such information (e.g. program logic, algorithms, or program language) is provided to the licensee with no limitation on the disclosure to others of such information, then the value to the licensor would have diminished and therefore would be seen as an alienation of a right.

The researcher notes the difficulty in determining the actual nature of transactions as to whether they are 'royalty' as defined or not. This report provides guidance by providing the underlying principles arising from the literature review and through an analysis of the Commentary issued by the OECD. It is clear that a lot of guidance and research is still required in the draft Interpretation Note issued by SARS with regard to know-how and therefore hope that this research will make the task for the authorities easier. It is therefore imperative that each case is analysed in detailed based on its own facts and decided on its own merits to ensure the correct tax treatment is arrived at.

The concept of 'due and payable' was also analysed and a reference was made to the SARS Comprehensive Guide to Dividends Tax and literature review. It was noted that for an amount to be 'due and payable', the amount must not only be owing to a person, but a person must have the right to claim payment of it.

The researcher also provided an overview of the exemption provisions of Part IVA of the Act. Section 49D(1)(*b)* indicates that a foreign person will be exempt from withholding tax if the amount being paid is effectively connected with a permanent establishment of that foreign person in South Africa. The principle noted from the OECD commentary is that a right or property in respect of which royalties are paid is effectively connected with a permanent establishment of such foreign person if the 'economic' ownership of that right or property is attributable to that PE. Economic ownership of the property or right is linked to who bears the risks and rewards attached to the property or right.

The discrepancies between the domestic law and double tax agreements with regard to the withholding taxes on royalty were also analysed. It was noted that it is not always clear for each country that computer software will form part of the intellectual property/rights

included in the definition of royalty in the OECD MTC. The OECD MTC refers to the use or right of use of any copyright of literary, artistic or scientific work. To provide more clarity, some treaties have specifically mentioned computer software in the definition of royalty in the Article dealing with royalty. It is recommended that for any new DTAs entered, such clarity must be provided to avoid any future dispute in that regard.

The second and major discrepancy noted was that relating to technical knowledge or information. The definition of royalties under the OECD MTC does not include technical knowledge or information whereas section 49A of the Act includes in the definition of royalty, amounts paid for the imparting or undertaking to impart technical knowledge or information. It was noted that some DTAs align with the definition of royalty in section 49A and includes technical knowledge or information. As a last discussion point on the discrepancies between the OECD MTC and the South African domestic law, the arms' length provisions of the OECD MTC where discussed. The effect of the provision is that the foreign person can only claim a reduced rate relief under the treaty to the extent that the amount is arms' length. The excess will be subject to withholding tax at 15% in South Africa.

Section 9(1) of the Currency and Exchange Act empowers the President of the Republic to make regulations on any matter directly or indirectly affecting or related to currency, banking or exchanges. The President has assigned such powers to the Minister of Finance, who in turn appointed the SARB to carry out certain of the powers and functions assigned to the Treasury by the Currency and Exchange Act regulations. The following powers and functions have not been assigned to SARB: regulation 3(5) and (8), 16, 20 and 22. FinSur, within SARB, therefore administers exchange control in South Africa.

Regulation 3(1)(c) prohibits any payment to, or in favour, or on behalf of a person resident outside the Republic, or place any sum to the credit of such person except approved by SARB. Certain guidelines have been issued by FinSurv which provides an overview of those permissible transactions relating to foreign exchange that can be affected by Authorised Dealers without further approval from the FinSurv.

Regulation 22 provides for a penalty system to ensure compliance with the exchange control regulations. Case law indicate that the object of exchange control is to control foreign exchange in the public interest and therefore should not be used as a measure to invalid any contractual obligations under a contract just because such exchange control regulations have not been complied with. It was noted that consent can be granted by FinSurv even after the event.

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