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The South African Revenue Service
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RE: Draft Interpretation Note: Withholding Tax on Royalties

We write to comment on the draft interpretation note on sections 49A to 49H of the Income Tax Act which relates to the withholding tax on royalties.

A. Interpretation of the section 49A definition of royalty

In terms of section 49A "royalty" 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; or

(b) 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.

This definition is used for the purposes of the withholding tax on royalties in section 49A to 49H as well as for the purposes of the exemption from normal tax under section 10(1)(l). The source rules in section 9 contains a narrower definition of "royalty" (paragraph (a) of the above definition) but then goes on to include both paragraph (a) and paragraph (b) amounts in its SA source provisions.

Therefore, the same definition is effectively used for these key domestic law provisions.

The OECD Model Double Tax Agreement contains a narrower definition in Article 12, namely:

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.

Therefore, the OECD Model DTA definition does not include the phrase payments for "the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information."

Even though the OECD Model DTA definition is narrower than our domestic definition, we submit that it is important to refer to the extensive OECD Model DTA Commentary on Article 12 in interpreting the definition of royalty as it carries weight in the areas of overlap and diversion.

Paragraph (a) of the section 49A definition of royalty

The treatment of payments for the use of computer software should be specifically addressed for the sake of clarity. The OECD Model DTA Commentary on the treatment of payments for the use of computer software should be considered – see paragraph 12 of the OECD Commentary on Article 12. Often, payments for software cannot not be regarded as payments for the use of intellectual property since the user has no right to use the copyright in the software, but merely to use the software – akin to reading a book compared to having the right to publish or copy the book. Depending on the circumstances, such payments may have to be dealt with under Article 7, business profits.

Paragraph (b) of the definition of royalty

The interpretation note only refers to the dictionary meaning of various terms in interpreting paragraph (b) of the definition. The interpretation of this paragraph should take into account the international interpretation of similar concepts (know-how) used in double taxation agreements and the OECD Model DTA Commentary. In this regard see paragraph 11 of the OECD Commentary on Article 12 of the OECD Model DTA. The OECD Commentary emphasises that a distinction must be made between payments for the supply of "know-how" (royalties) and payments for services or "show-how" (fees for rendering of services). Payments for show-how can only be included in the definition of a royalty if they are ancillary to the supply of know-how.

"11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 is referring to the concept of "know-how" …

> 11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof.
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> 11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7.
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> 11.3 The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties."

It is stated under paragraph 4.1.2 (e) of the interpretation note that:

"Thus, 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."

This statement may create the incorrect impression that any payment for imparting scientific, technical, industrial or commercial knowledge or information would be considered a royalty, regardless of whether the other requirements are met. For example, that any fee paid for instruction or training that is provided by a knowledgeable person would be a royalty. It would be helpful if the distinction between royalties and fees for services rendered under such circumstances is clearly drawn in the interpretation note.

More guidance on the meaning of technical know-how should also be given, to explain the distinction between providing technical assistance and imparting of technical knowledge. This guidance could be based on the OECD Commentary.

B. Exemptions from withholding tax under section 10(1)(l)

Where the IP, knowledge and information in respect of which that royalty is paid is not effectively connected with a SA permanent establishment of a foreign company, the royalty will be exempt from the normal tax and subject to the royalty withholding tax. We recommend that further clarity should be provided regarding the determination of whether a royalty is effectively connected with a SA permanent establishment with reference to the guidance provided by the OECD Commentary and the OECD transfer pricing guidelines.

For example, in terms of paragraph 21.1 of the OECD Model DTA Commentary on Article 12:

"A right or property in respect of which royalties are paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the "economic" ownership of that right or property is allocated to that permanent establishment under the principles developed in the Committee's report entitled Attribution of Profits to Permanent Establishments1 (see in particular paragraphs 72 to 97 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the "economic" ownership

of a right or property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the royalties attributable to the ownership of the right or property, the right to any available depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that right or property)."

C. Reduction of the withholding tax rate

The potential reduction of the withholding tax rate by a tax treaty is briefly discussed under paragraph 4.8 of the interpretation note. The following considerations are not discussed:

As discussed under paragraph A above, the definition of royalties in many of our tax treaties (for example those based on the OECD Model DTA) are narrower than the definition of royalties in our domestic legislation (including our deemed source rules and our withholding tax rules). Fees for the rendering of any assistance or service in connection with the application or utilisation of know-how do not fall into the OECD Model DTA definition but falls into the domestic definition of a royalty. This means that certain amounts that are royalties for withholding tax purposes may not qualify for treaty relief under the royalty article but may under certain circumstances fall under the business profits article (if the amount is attributable to a SA permanent establishment but the IP/know-how is not effectively connected to the PE). Business profits are subject to tax on a net basis after allowable deductions. This may mean that the net profit is less than the 15% royalty withholding tax rate. Guidance should be provided on how the royalty withholding tax should be determined in respect of royalties that qualify for tax treaty relief under the business profits article.

An example would be where a foreign company has developed and owns the intellectual property in a patent. The foreign company grants a license to a South African company to use the patent and related know-how. The foreign company retains the economic ownership in the patent and related know-how. The foreign company also agrees to provide services to the South African company by sending staff to South Africa for 9 months to train the employees of the South African company on the use of the patent and related know-how and assist them with the implementation thereof. The staff of the foreign company creates a permanent establishment for it in South Africa. The DTA between the jurisdiction of the foreign company and South Africa is based on the OECD Model DTA.

D. Withholding tax on royalties declaration form

It is not clear whether a taxpayer has to obtain a new declaration form from a foreign person before each payment to them to allow for treaty relief. Guidance on what would practically be acceptable from a documentation perspective to apply the treaty relief (e.g. annual declaration, or a time period for which a declaration from a foreign supplier will remain valid) would be helpful.

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We welcome the opportunity to comment on the draft interpretation note and look forward to future engagements.

Yours sincerely

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