

BINDING PRIVATE RULING: BPR 111

The following legislative changes should be noted - the repeal of section 35 and the enactment of sections 49A - 49H.

DATE: 12 March 2012

ACT : INCOME TAX ACT, NO. 58 OF 1962 (the Act)
SECTION : SECTIONS 11(a) AND 35
SUBJECT : RESEARCH AND DEVELOPMENT EXPENDITURE PAID TO A FELLOW GROUP COMPANY WHICH IS NOT A RESIDENT OF SOUTH AFRICA

1. Summary

This ruling deals with the question as to whether research and development expenditure paid to a company within a group, which is not a resident of South Africa, will be deductible for income tax purposes and whether the payment will constitute a royalty for purposes of the withholding tax on royalties.

2. Relevant tax laws

This is a binding private ruling issued in accordance with section 76Q of the Act.

In this ruling legislative references to sections are to sections of the Act applicable as at 15 July 2010 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of –

- section 11(a);
- section 23(g); and
- section 35.

3. Parties to the proposed transaction

The Applicant: A company which is a “resident” as defined in section 1 and forms part of an extensive group of companies

The Research Company: A company which is not a “resident” as defined in section 1 and forms part of the

same extensive group of companies as the Applicant

4. Description of the proposed transaction

Background

The research and development (R&D) requirements of the companies within a group of companies (the Group) overlap. The Group agreed to centralise its R&D projects as well as certain administrative services required by the companies within the Group in one company.

The Research Company was established in 2008 for this purpose. The Research Company coordinates all the R&D projects for the Group's business segments. All intellectual property of the Group is developed by and owned by the Research Company.

The Applicant is currently not a participant in the R&D structure and is also not obliged to join the R&D structure. The Applicant would have been a participant from the inception of the Research Company, but was left out due to the time it took the Applicant to obtain board approval to participate in the R&D structure. To date this approval has not been obtained.

During 2008 the Research Company and certain companies within the Group (excluding the Applicant) entered into an agreement (the R&D Agreement), in terms of which the Research Company agreed to provide "assistance service", as described below, to these companies.

In terms of the R&D Agreement, the assistance service is predominantly focussed on the preparation and improved utilisation of materials, the development and improvement of relevant manufacturing processes and products and the development of new types of products to suit customers' needs.

A participant in the R&D structure has access to the following benefits –

- access to intellectual property rights which are developed through the Research Company; and
- assistance benefits, namely benefits from administration and central services undertaken by the Research Company, including R&D competition watch, human resources and training co-ordination, communication, quality management co-ordination, finance and controlling co-ordination, project and document management IT tools. Advice for development of IP rights, external exploitation and patent management.

As part of the Applicant's business operations, the Applicant requires the use of continually developed intellectual property and other administration services in the production of its products. It is accordingly proposed that the Applicant enter into the R&D Agreement with the Research Company, to share in the benefits offered by the Research Company.

The benefits will, however, come at a cost, which will take on the form of an introductory fee as well as annual expenditure.

In order to regulate the participation of the Applicant in respect of the right of use of the assistance service as from 1 January 2009, an addendum to the R&D Agreement has been drafted (the Addendum).

The Applicant will, in terms of the Addendum, become a party to the R&D Agreement with corresponding rights to obtain the benefits of the assistance service as per the terms of the R&D Agreement.

Salient aspects of the R&D Agreement

The Research Company acts as a centralised co-ordinator for the management of the R&D programmes for the companies within the Group. In its function as centralised co-ordinator, the Research Company –

- establishes R&D Centres to perform the R&D as requested from time to time;
- is the owner of all intellectual property developed by the R&D Centres, subject to the rights of the economic owners to exploit it for their own production purposes;
- is the sole person authorised to licence any intellectual property rights as developed by the R&D Centres; and
- undertakes various administration and central services as contemplated above.

The companies entering into the R&D Agreement with the Research Company submit requests on an annual basis for specific R&D projects required to be undertaken during a particular year. Based on the requests submitted by these companies, the R&B programme that fulfils the R&D requirements of the Group is finalised by a strategic steering committee.

Subsequent to the approval of the Group's Annual R&B Programme, Annual R&B Agreements are concluded between the Research

Company and each of the companies requesting the particular R&D projects to be undertaken in a particular year, in terms of which –

- the projects for the year in question are defined;
- the forecast budgets for such projects are stipulated;
- the particular projects in respect of which the companies have “expressed an interest” are identified; and
- the cost sharing key and determination of the share of the total cost of the Annual R&B Programme to be borne by each company is stated.

Annual R&D Agreements have been concluded between the Research Company and certain of the other companies within the Group. It is proposed that the Applicant first conclude an Annual R&B Agreement prior to the Applicant and the Research Company concluding the Addendum. The Applicant will be entitled to benefit from the assistance service rendered by the Research Company prior to the Applicant concluding the Addendum and becoming party to the R&D Agreement.

The proposed transaction

The Applicant will pay the following to the Research Company –

- an introductory fee in respect of the use of the benefits associated with the assistance service which was made available by the Research Company to the companies as parties to the R&D Agreements prior to the Applicant joining as participant, described more fully below;
- a share of the total cost of future projects in the Group’s Annual R&D Program in which the Applicant expresses an interest (annual expenditure); and
- the annual cost, plus a 10% mark up on the administration and central services rendered by the Research Company (annual expenditure).

In relation to the introductory fee, the Research Company has established best practices, procedures, formulas, etc. since its inception in 2008 which will be shared with the Applicant if the Applicant enters as a participant. This will entail an investigation into the Applicant’s own practices and processes. Once this investigation has been done, the outcome will dictate the extent to which the Research Company will assist the Applicant in implementing steps, processes and procedures. The introductory fee will be paid for the following –

- a review of existing processes and practices;
- the imparting of knowledge;
- the implementation of such knowledge; and
- the use of such imparted and implemented knowledge.

Invoices for future annual expenditure will be issued by the Research Company to the Applicant on a quarterly basis once the Applicant has become a participant.

The following features of the R&D structure are important –

- the companies concluding the Annual R&D Agreement will only do so to the extent that they require any particular assistance service to be provided in any particular year;
- the assistance service will be rendered by the Research Company on an annual basis and there will be a continuous review of the requirements of the companies concerned; and
- the liability to make payments for any assistance service provided by the Research Company in terms of any Annual R&D Agreement –
 - will arise only to the extent that the company concerned had specifically requested (or “expressed an interest in”) that particular assistance service; and
 - is solely for assistance service rendered and not for the use of intellectual property or for the acquisition of any asset.

5. Conditions and assumptions

This ruling is not subject to any conditions or assumptions.

6. Ruling

The ruling made in connection with the proposed transaction is as follows:

- The Applicant will be entitled to claim a deduction under the provisions of section 11(a) read together with section 23(g) in respect of expenditure incurred in –
 - paying the introductory fee to the Research Company; and
 - making any annual payment to the Research Company for the assistance service rendered to it by the Research Company in terms of the R&D Agreement and each Annual

R&D Agreement concluded between the Applicant and the Research Company, in anticipation of the Applicant and the Research Company concluding the Addendum.

- In respect of the annual payment, the Applicant will not be liable to make a payment to the Commissioner in respect of the Research Company's liability for tax (withholding tax on royalties) under the provisions of section 35.
- The portion of the introductory fee paid that relates to the imparting of knowledge, implementation of such knowledge, and finally, the use of such knowledge, formulas and processes, will constitute a royalty as contemplated in section 35.

7. General Note

None of the payments made to the Research Company are payments made for scientific and technological research and development as provided for under section 11D.

8. Period for which this ruling is valid

This binding private ruling is valid for a period of five (5) years as from July 2010.

Issued by:

**Legal and Policy Division: Advance Tax Rulings
SOUTH AFRICAN REVENUE SERVICE**