

**DRAFT INTERPRETATION NOTE**

DATE:

**ACT : INCOME TAX ACT 58 OF 1962**  
**SECTION : SECTION 23I**  
**SUBJECT : PROHIBITION OF DEDUCTIONS FOR CERTAIN INTELLECTUAL PROPERTY**

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### **Preamble**

In this Note unless the context indicates otherwise –

- “**connected person**” means a connected person as defined in section 31(4);
- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962; and
- any other word or expression bears the meaning ascribed to it in the Act.

All guides and interpretation notes referred to in this Note are available on the SARS website at [www.sars.gov.za](http://www.sars.gov.za). Unless indicated otherwise, the latest issues of these documents on the website should be consulted.

## **1. Purpose**

This Note provides guidance on the interpretation and application of section 23I, which relates to the prohibition of deductions for tainted intellectual property.

## **2. Background**

Transactions involving the use of intellectual property belonging to another person normally carry a charge in the form of a royalty. Usually the payment received will fall within the recipient’s gross income and the payee will be allowed to claim a deduction under section 11(a) for the expenditure incurred in paying the royalty.

Instances arose in which self-developed intellectual property was sold or transferred to another party connected to the resident developer. The connected person typically paid no tax or tax at a very low rate. These transactions were designed to reduce the group’s overall tax liability in South Africa. Section 23I was therefore inserted<sup>1</sup> with the aim of preventing the avoidance of tax.<sup>2</sup>

Section 23I prohibits a deduction of any expenditure incurred for the right or permission to use intellectual property and other expenditure which is directly or indirectly related to such expenditure.

## **3. The law**

The relevant sections of the Act as well as relevant definitions are quoted in the **Annexure**.

## **4. Application of the law**

### **4.1 Definitions [section 23I(1)]**

Section 23I(1) contains a number of definitions which apply for the purposes of the section.

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<sup>1</sup> By section 37(1) of the Revenue Laws Amendment Act 35 of 2007 and applies to expenditure incurred on or after 1 January 2009.

<sup>2</sup> *Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008.*

#### 4.1.1 Definition of “intellectual property”

Under section 231(1), “intellectual property” means any –

- patent as defined in the Patents Act 57 of 1978 including any application for a patent under that Act;
- design as defined in the Designs Act 195 of 1993;
- trade mark as defined in the Trade Marks Act 194 of 1993;
- copyright as defined in the Copyright Act 98 of 1978;
- patent, design, trade mark or copyright defined or described in any similar law to that referred to in the above bullet points of a country other than South Africa;
- property or right of a similar nature to that in the above bullet points; and
- knowledge connected to the use of such patent, design, trade mark, copyright, property or right.

##### *Patent*

The term “patent” is defined in section 2 of the Patents Act 57 of 1978 and means –

“a certificate in the prescribed form to the effect that a patent for an invention has been granted in the Republic”.

##### *Design*

The term “design” is defined in section 1(1) of the Designs Act 195 of 1993 and means –

“an aesthetic design or a functional design;”

##### *Trade mark*

Under section 2(1) of the Trade Marks Act 194 of 1993, the term “trade mark”, –

“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”.

##### *Copyright*

The term “copyright” as defined in section 1(1) of the Copyright Act 98 of 1978 means –

“copyright under this Act”.

*Patent, design, trade mark or copyright defined or described in any similar law of a country other than South Africa*

In the United Kingdom, for example, 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 231(1), these works will also be regarded as intellectual property as defined under section 231.

*Property or right of a similar nature to any patent, design, trade mark or copyright as discussed above*

The concept “property of a similar nature” was analysed in *C: SARS v SA Silicone Products (Pty) Ltd.*<sup>3</sup> The court held that for property to be similar in nature, it should possess common fundamental characteristics. Minor or superficial similarities are not sufficient to regard the property as similar in nature.

*Knowledge connected to the use of such patent, design, trade mark, copyright, property or right*

The knowledge imparted must be fundamental to the use or application of the intellectual property, for example, operating or instruction manuals for the use of a design.

#### 4.1.2 “Taxable person”

A “taxable person”<sup>4</sup> means any *person* other than –

- a non-resident;<sup>5</sup>
- exempt entities or persons that are mentioned in sections 10(1)(a), 10(1)(cA) and 10(1)(t);<sup>6</sup>
- any fund contemplated in section 10(1)(d)(i) or (ii);
- any public benefit organisation or recreational club as defined in sections 30 and 30A respectively and which have been approved by the Commissioner; or
- any closure rehabilitation company or trust provided for under section 37A.

A “person”, as defined in section 1(1), includes –

- an insolvent estate;
- the estate of a deceased person;
- any trust; and
- any portfolio of a collective investment scheme,

but does not include a foreign partnership.

A “taxable person” is thus any person other than those specifically excluded by the definition of that term. Generally, those persons that have been excluded from the definition are those that are exempt from or not subject to South African tax.

#### 4.1.3 “End user”

To qualify as an “end user”, the person has to be a “taxable person” as defined in section 23I or have a permanent establishment in South Africa that uses intellectual property or any corresponding invention to derive income.

<sup>3</sup> [2004] 2 All SA 1 (SCA), 66 SATC 131 at 139.

<sup>4</sup> Defined in section 23I(1).

<sup>5</sup> See **Annexure** for the definition of “resident” in section 1(1).

<sup>6</sup> For more information on these tax-exempt entities, see the *Tax Exemption Guide for Public Benefit Organisations in South Africa*.

The term “corresponding invention” is not defined in the Act. The *Merriam-Webster Dictionary* defines “corresponding” as –<sup>7</sup>

“: having the same characteristics as something else: matching something else

“: directly related to something”.

The term “invention” is defined in the *Merriam-Webster Dictionary* as –<sup>8</sup>

“something invented: as (1) : a product of the imagination; *especially* : a false conception (2) : a device, contrivance, or process originated after study and experiment”.

Applying the above definition, “corresponding invention” refers to another invention which has similar features to the one used by the end user.

The term “permanent establishment” is defined in section 1(1) and 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”.

Paragraph 1 of Article 5 of the Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development, Condensed Version 15 July 2014 (OECD Model Tax Convention), defines “permanent establishment” as –

“a fixed place of business through which the business of an enterprise is wholly or partly carried on”.

Paragraph 2 of Article 5 states that a “permanent establishment” includes –

“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”.

In determining whether a permanent establishment exists, the facts of each case must be considered.

The definition of “end user” does not apply to persons earning income *mainly* from granting the use, right of use<sup>9</sup> or permission to use intellectual property or an invention (generally under a licence or royalty agreement).

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<sup>7</sup> [www.merriam-webster.com/dictionary/corresponding](http://www.merriam-webster.com/dictionary/corresponding) [Accessed 9 January 2018].

<sup>8</sup> [www.merriam-webster.com/dictionary/invention](http://www.merriam-webster.com/dictionary/invention) [Accessed 9 January 2018].

<sup>9</sup> According to [www.investorwords.com/13812/right\\_to\\_use.html](http://www.investorwords.com/13812/right_to_use.html) [Accessed 9 January 2018], “right to use” means “the legal right to use or occupy a property”.

In *SBI v Lourens Erasmus (Eiendoms) Bpk*<sup>10</sup> Botha JA held that the word “mainly” prescribed a purely quantitative standard of more than 50%. This requirement means that a taxpayer will fall outside the ambit of the definition of “end user” if the taxpayer’s trade consists mainly of granting to another person the use, right of use or permission to use intellectual property or an invention in order to derive income instead of making use of the intellectual property itself.

#### 4.1.4 Definition of “tainted intellectual property”

Intellectual property will be classified as “tainted intellectual property” if any one of the requirements listed in paragraphs (a) to (d) of the definition of “tainted intellectual property” are met.

##### a) Paragraph (a)

Under paragraph (a) the intellectual property must have been the property of the end user or of a taxable person that is or was a connected person, as defined in section 31(4), in relation to the end user (see **4.1.2** and **4.1.3** for a discussion of “taxable person” and “end user” respectively).

Section 31(4) defines a connected person as –<sup>11</sup>

“a connected person as defined in section 1: Provided that the expression ‘and no holder of shares holds the majority voting rights in the company’ in paragraph (d)(v)<sup>12</sup> of that definition must be disregarded”.

For the purposes of section 23I, a company will thus be a connected person in relation to a company if it holds at least 20% of the equity shares or voting rights in that company.

##### b) Paragraph (b)

Paragraph (b) requires the intellectual property to be held by a taxable person, which means that the intellectual property must be owned by any person other than those specifically excluded in the definition of “taxable person” (see **4.1.2**). The assignment or cession of the rights to the intellectual property to another person by the developer will result in the developer no longer being the owner. Instead, the person who has acquired the intellectual property will be the owner of the property. The new owner must then meet all the requirements of the section to be regarded as a taxable person and for the intellectual property to be considered tainted.

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<sup>10</sup> 1966 (4) SA 444 (A), 28 SATC 233 at 245.

<sup>11</sup> For the full definition of “connected person” as defined in section 1(1), see **Annexure**. For commentary on the definition, see Interpretation Note 67 “Connected Persons”.

<sup>12</sup> Under paragraph (d)(v) of the definition of “connected person” in section 1(1), in relation to a company, a connected person means any other company if at least 20% of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company.

**Example 1 – Property of a taxable person***Facts:*

Q is an end user of intellectual property which belongs to R. R is an approved public benefit organisation as defined in section 30 of the Act.

*Result:*

For paragraph (b) of the definition of “tainted intellectual property” to apply, the intellectual property must be the property of a taxable person. A taxable person, as defined, excludes a public benefit organisation which means that R is not a taxable person and section 23I will not apply.

Section 23I also applies to bare *dominium* intellectual property schemes. These schemes involve the ownership of intellectual property by a taxable person (the bare *dominium* holder), while the right of use is vested in a taxable end user. Any tax advantage from the payment of associated royalties is eliminated through section 23I. No connected person relationship is required.<sup>13</sup>

**Example 2 – Payment of associated royalties***Facts:*

ABC and DEF are both taxable persons. ABC sold its intellectual property to DEF and its business to GHI. DEF sold promissory notes to JKL, a foreign entity, for an amount equal to the price paid for the intellectual property. DEF then licensed the intellectual property to GHI in exchange for royalties to be paid directly to JKL. Assume that JKL will not be required to include the amounts received in income for South African tax purposes (see 4.2.2).

*Result:*

For paragraph (b) of the definition of “tainted intellectual property” to apply, the intellectual property must be the property of a taxable person. DEF, a taxable person, owns the intellectual property. As a result, the royalties paid by GHI to JKL for the use of the intellectual property owned by DEF will not be allowed as a deduction, since they relate to tainted intellectual property.

**c) Paragraph (c)**

Under paragraph (c) intellectual property will be tainted intellectual property if a *material part* of it was used by a taxable person in *carrying on a business* and the end user of the property acquired that business or a material part of it as a *going concern*, that is, while it was active and operational.<sup>14</sup> This determination must be done by taking into consideration all the facts of the particular case.

It is not a requirement for the taxable person who owned the intellectual property and the end user in this scenario to be connected persons in relation to each other.

<sup>13</sup> Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008.

<sup>14</sup> See VAT 404 – Guide for Vendors in paragraph 6.3.3 and Interpretation Note 57 “Sale of an Enterprise or Part thereof as a Going Concern” for more information on what is considered a “going concern”.

The aim of this paragraph is to prevent the stripping of a business of its intellectual property rights as part of a business takeover which would have the effect of potentially permanently depriving the South African tax base of royalty income.

Paragraph (c) contains important concepts which have to be considered.

#### *Material part*

The term “material part” is not defined in the Act and its normal grammatical meaning must therefore be considered. In order for something to be “material”, it must be significant or important.<sup>15</sup> Thus, in order to be classified as tainted intellectual property, a taxable person must have made use of a significant portion of the intellectual property while carrying on a business. Deciding what a “significant portion” amounts to is subjective. It is, however, considered that 20% or more would be material.

#### *Carrying on a business*

The word “business” is not defined in the Act, but “trade” is defined in section 1(1) and includes, amongst other things, business.<sup>16</sup> Although “business” is included in the definition of “trade”, the term “carrying on a trade” is different from “carrying on a business”.

Kuper J in ITC 883<sup>17</sup> referred to *Joel & Joel v CIR* in which it was stated in relation to the meaning of “carrying on a business” that –<sup>18</sup>

“ ‘unless there is something in the Act to the contrary the usual commercial meaning must be given to the words.’ ”.

The commercial meaning of the term “business” is defined in the *Law Dictionary*<sup>19</sup> as follows:

“To prosecute or pursue a particular avocation or form of business as a continuous and permanent occupation and substantial employment. A single act or business transaction is not sufficient, but the systematic and habitual repetition of the same act may be.”

In determining whether a person is carrying on business, all the surrounding circumstances must be considered. This approach was adopted by Beadle JA in *Estate G v COT*, by referring to the above reference of Kuper J in ITC 883, in which the following was stated:<sup>20</sup>

“It is quite impossible to define precisely this ‘commercial’ meaning so as to have a yardstick with which to measure any particular activities. The sensible approach, I think, is to look at the activities concerned as a whole, and then to ask the question: Are these the sort of activities which, in commercial life, would be regarded as ‘carrying on business’? The principal features of the activities which might be examined in order to determine this are their nature, their scope and magnitude, their object (whether to make a profit or not), the continuity of the activities concerned, if

<sup>15</sup> [www.oxforddictionaries.com/definition/english/material](http://www.oxforddictionaries.com/definition/english/material) [Accessed 9 January 2018].

<sup>16</sup> See Interpretation Note 33 “Assessed losses: Companies: The ‘Trade’ and ‘Income from Trade’ Requirements” for a detailed discussion of the trade requirement.

<sup>17</sup> (1959) 23 SATC 328 (T) at 330.

<sup>18</sup> 1922 WLD 29, 33 SATC 106 at 111.

<sup>19</sup> [www.thelawdictionary.org/carry-on-business/](http://www.thelawdictionary.org/carry-on-business/) [Accessed 9 January 2018].

<sup>20</sup> 1964 (2) SA 701 (SR), 26 SATC 168 at 172 and 173.



the acquisition of property is involved, the intention with which the property was acquired. This list of features does not purport to be exhaustive, nor are any one of these features necessarily decisive, nor is it possible to generalize and state which feature should carry most weight in determining the problem. Each case must depend on its own particular circumstances.”

In *Platt v CIR*,<sup>21</sup> Juta JA referred to *Smith v Anderson* in which case Jessel MR discussed the meaning of the word “business” and adopted the following definition from the *Imperial Dictionary*:<sup>22</sup>

“[A]nything which occupies the time and attention and labour of a man for the purpose of profit in business’.”

It was, however, held in *Modderfontein Deep Levels Ltd & another v Feinstein*,<sup>23</sup> that as a rule a trade or business is carried on for the purpose of making a profit, but profit-making is not of the essence of trading.

Moreover, in determining whether a person carries on a business, consideration should be given to such person’s activities in the light of the intention with which it is undertaken. In this regard, Juta JA stated the following in *Platt v CIR*:<sup>24</sup>

“As was stated by Jessel M.R. in *Smith v Anderson*(*supra*), in the case of a company formed for a certain purpose, it would be said at once that it was carrying on business, because it was formed for that purpose, and for nothing else, and from the very nature of the association the idea of continuity is inferred.”

The question whether a person is carrying on a business must accordingly be determined on the facts of each case. In *Morrison v CIR* Schreiner JA stated that one would think that –<sup>25</sup>

“where the question whether a man was carrying on a trade or business depends on how much weight is to be given to the evidence of the nature, extent and duration of his operations, the question would be one of fact, and that this would most clearly be so where the inquiry involves the drawing of inferences from his conduct as to his purpose or motive in carrying out the operations”.

### *Going concern*

The term “going concern” is not defined in the Act and reliance must thus be placed on case law and dictionaries to determine its meaning.

In *Milner Street Properties (Pty) Ltd v Eckstein Properties (Pty) Ltd*<sup>26</sup> Thirion J, in analysing the meaning of “going concern”, quoted with approval the judgment in *General Motors SA (Pty) Ltd v Besta Auto Component Manufacturing (Pty) Ltd and Another*,<sup>27</sup> in which Kannemeyer J said the following:

“The Shorter Oxford English Dictionary 3rd ed (1978) defines the phrase [going concern] as “one in actual operation”. The only judicial consideration of the term I am able to find is that in two Australian cases referred to in *Words and Phrases Legally Defined* 2nd ed Vol 2 at 323. I have no access to the reports themselves but refer to

<sup>21</sup> 1922 AD 42, 32 SATC 142 at 148.

<sup>22</sup> (1880) 15 ChD 247 at 258.

<sup>23</sup> 1920 TPD 288 at 294.

<sup>24</sup> 1922 AD 42, 32 SATC 142 at 148.

<sup>25</sup> 1950 (2) SA 449 (A), 16 SATC 377 at 386.

<sup>26</sup> 62 SATC 451 at 461.

<sup>27</sup> 1982 (2) SA 653 (SECLD) at 657.

the extracts in Words and Phrases. In *Ferne v Wilson* (1900) 26 VLR 422 at 437 Madden, CJ said in respect of an advertisement for tenders for a business so described:

‘The words ‘as a going concern’ are merely intended to mean that the shop is being kept open instead of being closed up, and that the customers are being kept together, so that if the purchaser wishes to keep on the business he can do so; that . . . the vendors only propose to sell the stock and fixtures, and they leave it to the person who buys to decide whether he will carry on the business or not, and that meanwhile, lest the purchaser should care to carry on the business, they keep it open till he takes his choice. In some cases they shut up the shop prior to the sale; in other cases they keep it ‘going’ so that the trade may not be broken and dispersed.’ ”

Thirion J went on to state the following:

“In Reference under Electricity Commission (Balmain Electric Light Co Purchase) Act 1950 (1957) SR (NSW) 100 at 131 Sugerman, J is reported to have said:

‘To describe an undertaking as a ‘going concern’ imports no more than that at the point of time to which the description applies, its doors are open for business; that it is then active and operating, and perhaps also that it has all the plant, etc which is necessary to keep it in operation, as distinct from its being only an inert aggregation of plant.’ ”

### **Example 3 – Acquiring a business as a going concern**

#### *Facts:*

ABC and ZED are South African companies. ABC owned intellectual property which it licensed to ZED. ABC decided to sell its business to ZED as a going concern. ABC and ZED both fell within the definition of “taxable person” in section 23I(1). However, the sale agreement between ABC and ZED excluded all intellectual property rights owned by ABC. Instead, the intellectual property rights were sold to a foreign company, CHUM Inc. which licenced the property to ZED. As part of the intellectual property agreement between the entities, ZED is obliged to make royalty payments to CHUM Inc.

#### *Result:*

In order for intellectual property to qualify as “tainted intellectual property” as defined, paragraph (c) of the definition requires that the intellectual property must have been used by a taxable person in carrying on a business (ABC) while it was owned by a taxable person (ABC). Further, the end user of that property (ZED) must have acquired that business or a material part of it as a going concern. The intellectual property owned by CHUM Inc., therefore constituted tainted intellectual property.

Since the royalty payments made by ZED to CHUM Inc were made in relation to tainted intellectual property, ZED does not qualify for a deduction under section 23I(2).

Note that a connected person relationship between the parties is not required for paragraph (c) of the definition of “tainted intellectual property” to apply.

**d) Paragraph (d)**

Paragraph (d) was inserted to address concerns that an overly broad anti-avoidance provision in relation to research and development arrangements may discourage foreign companies from using South African subsidiaries as intellectual property developers.

Paragraph (d) stipulates that intellectual property will be regarded as tainted intellectual property if it was discovered, devised, developed, created or produced by the end user or by a taxable person that is a connected person in relation to the end user. It also requires that a certain percentage of participation rights be held by the end user together with any taxable person that is a connected person in relation to the end user in a person to whom an amount is received or accrues in relation to that intellectual property.

For this paragraph to apply, the end user or taxable person must have made or invented the intellectual property. In other words, the intellectual property must not have been acquired from another (for example through assignment or cession) but must have come into being through the ingenuity of the end user or taxable person.

*Participation rights*

Paragraph (d) makes reference to “participation rights” as defined in section 9D.

Section 9D(1) states that for purposes of that section, “participation rights” in relation to a foreign company means –

- “(a) the right to participate in all or part of the benefits of the rights (other than voting rights) attaching to a share, or any interest of a similar nature, in that company; or
- (b) in the case where no person has any right in that foreign company as contemplated in paragraph (a) or no such rights can be determined for any person, the right to exercise any voting rights in that company”.

In other words, participation rights represent the right to participate in all or part of the benefits of the rights attaching to a share, or any interest of a similar nature, in a foreign company.

If the participation rights in the foreign company cannot be determined or if no person has any participation rights in the foreign company, the voting rights must be used to determine the participation rights in the company.

*20% requirement*

In paragraph (d)(i) of the definition of “tainted intellectual property”, the taxable person or end user must hold at least 20% of the participation rights in a person who receives an amount or to whom an amount accrues in consequence of granting the use, right to use or permission to use intellectual property.

The 20% requirement also applies to paragraph (d)(ii) of this definition. This paragraph states that if the receipt, accrual or amount is determined directly or indirectly in relation to the royalty expenditure incurred for the use, right of use or permission to use the intellectual property, at least 20% of the participation rights must be held by the end user, together with any taxable person that is connected to the end user, in a person who receives the amount or to whom the amount accrues.

Paragraph (d)(i) and (ii) operate in the alternative which means that only one subparagraph needs to be complied with in order for the intellectual property to be regarded as tainted intellectual property. This paragraph will usually be of relevance to controlled foreign companies (see 4.2.3).

**Example 4 – End user holding at least 20% participation rights in the person to whom royalties are paid**

*Facts:*

During the 2016 year of assessment, SA OpCo created SA R&D Co and was the sole shareholder. SA OpCo is a connected person in relation to SA R&D Co.

During this period, Foreign IP Co was formed and SA OpCo acquired 30% of the participation rights in it. Foreign IP Co entered into an agreement with SA R&D Co which had developed certain intellectual property to continue its research and development activities in South Africa. Under the agreement, Foreign IP Co funded the research and development and SA R&D Co's intellectual property was subsequently assigned to Foreign IP Co.

Foreign IP Co then licensed the intellectual property to SA OpCo in return for a percentage of royalties.

*Result:*

Since the intellectual property was developed by a connected person (SA R&D Co) in relation to SA OpCo and SA OpCo held a 30% participation right in Foreign IP Co, SA OpCo does not qualify for a deduction for the royalties paid to Foreign IP Co. This outcome is in consequence of the intellectual property being classified as "tainted intellectual property" under paragraph (d) of the definition of that term.

#### **4.2 Prohibition of deductions [section 23I(2)]**

With the exception of deductions allowed for the acquisition of intellectual property referred to in section 11(gC) and the trading stock provisions, section 23I(2) prohibits a deduction for –

- any amount of expenditure incurred for the use of tainted intellectual property [section 23I(2)(a)]; or
- any expenses which are calculated directly or indirectly on the expenditure for the use or right of use of or permission to use any tainted intellectual property [section 23I(2)(b)],

to the extent that the amount of expenditure does not constitute income received by or accrued to any other person or to the extent that the expenditure does not constitute a proportionate amount of net income which is not imputed to any resident under section 9D.

#### 4.2.1 Meaning of “amount” [section 231(2)(a)]

Section 231(2)(a) uses the words “any amount” of expenditure. The word “amount” is not defined in the Act but was judicially considered in *W H Lategan v CIR* in which Watermeyer J stated the following:<sup>28</sup>

“In his Lordship’s opinion the word “amount” had to be given a wider meaning and must include not only money but the value of every form of property earned by the taxpayer whether corporeal or incorporeal which had a money value.”

In *C: SARS v Brummeria Renaissance (Pty) Ltd & others*<sup>29</sup> the court held that even though something cannot be turned into money, this did not mean that it did not have a monetary value. Moreover, the court held that an objective test must be applied when determining whether an amount has a monetary value.

The disbursement of something other than money for the use, right of use or permission to use tainted intellectual property will be given a monetary value. The value taken into consideration for this purpose will usually be the market value<sup>30</sup> and will be treated in the same manner as a cash royalty.

#### 4.2.2 Conversion of royalties into financial instruments [section 231(2)(b)]

Section 231(2)(b) seeks to prevent taxpayers from avoiding tax by stopping transactions in which royalty expenditure is converted into financial instruments such as promissory notes and credit default swaps.

A “credit default swap” is defined in *Investopedia* as follows:<sup>31</sup>

“A swap designed to transfer the credit exposure of fixed income products between parties. A credit default swap is also referred to as a credit derivative contract, where the purchaser of the swap makes payments up until the maturity date of a contract. Payments are made to the seller of the swap. In return, the seller agrees to pay off a third party debt if this party defaults on the loan.”

In the types of transactions envisioned in section 231(2)(b), the licensor of intellectual property may attempt to claim variable costs which are directly or indirectly associated with the use of the tainted intellectual property and which do not constitute income of the person receiving these payments.

Under section 231(2)(b), a deduction is disallowed if the expenditure is determined directly or indirectly with reference to expenditure incurred for the use or right of use of or permission to use tainted intellectual property to the extent that the amounts of expenditure do not constitute income received by or accrued to any other person.

<sup>28</sup> 1926 CPD 203, 2 SATC 16 at 19. See also the *Comprehensive Guide to Capital Gains Tax* in paragraph 9.1.1.1 for a detailed discussion on the word “amount”.

<sup>29</sup> 2007 (6) SA 601 (SCA), 69 SATC 205.

<sup>30</sup> *Lace Proprietary Mines Ltd v CIR* 1938 AD 267, 9 SATC 349.

<sup>31</sup> [www.investopedia.com/terms/c/creditdefaultswap.asp](http://www.investopedia.com/terms/c/creditdefaultswap.asp) [Accessed 9 January 2018].

**Example 5 – Variable payments linked to royalty income***Facts:*

Y, a resident licensee, developed intellectual property and sold it to X, a resident licensor. Y and X then entered into an agreement under which Y would pay X royalty payments for the use of the intellectual property. Y and X are not connected persons in relation to each other.

X then concluded a credit default swap with a non-resident third party, Z. The credit default swap provided for variable payments by X to Z. These variable payments were determined with reference to the royalties received by X from Y. The variable payments received by Z did not constitute “income” in Z’s hands.

*Result:*

X will be denied deductions for the variable payments paid under the credit default swap because the payments by X –

- do not constitute income in the hands of Z; and
- are directly or indirectly linked to the intellectual property of X, a taxable person.

**4.2.3 Royalties not constituting income for the recipient**

Section 23I(2) prohibits the deduction of expenditure incurred in making a royalty payment to a recipient to the extent that the expenditure does not constitute income received by or accrued to the recipient. The words “*to the extent*” imply that it may be possible for part of the expenditure to constitute income. In these cases, a deduction will be denied only on the non-income portion derived by the recipient.

**Example 6 – Royalty payments which are not included in the recipient’s income***Facts:*

X, a South African resident and taxable person, developed certain intellectual property. In 2015, X sold the intellectual property to Z, a resident of country A, who subsequently licenced it to X. X sub-licensed the intellectual property to Y who is a connected person as defined in section 31(4) in relation to X. Y used the intellectual property to derive income making Y the “end user” as defined in section 23I(1).

In return for the use of the property, Y made royalty payments to X. The agreement between X and Z specifically stated that all royalty payments are ceded to Z and for the benefit of Z. Consequently, X did not include the receipt in gross income, since the royalties were effectively transferred to Z and were therefore not received by or accrued to X. The tax treaty between South Africa and country A provides that residents of Country A are subject to a zero rate of tax on royalty income derived from a South African source. Consequently, Z cannot be taxed on any receipts or accruals from a South African source.

*Result:*

Since the intellectual property was the property of a taxable person (X) who is a connected person in relation to the end user (Y), the intellectual property comprises tainted intellectual property [under paragraph (a) of the definition of “tainted intellectual property” in section 23I(1)]. In the absence of section 23I, a deduction would have been allowed to Y for the payments made while no royalty income would have been included in the gross income of Z in South Africa.

However, section 23I(2) prohibits a deduction for expenditure incurred for the use, right of use or permission to use any tainted intellectual property to the extent that the amount is not income in the hands of the other party.

Since Z is exempt from tax under the tax treaty between South Africa and country A, the payments received by Z cannot be subjected to tax in South Africa. Consequently, no deduction is permissible for the expenditure incurred by Y.

**4.2.4 Royalties not imputed to a resident**

Under section 23I(2) a deduction will not be allowed for expenditure incurred if –

“the amount of expenditure does not constitute a proportional amount of net income of a controlled foreign company an amount equal to which is included in the income of any resident in terms of section 9D”.

A controlled foreign company is a foreign company in which a South African resident directly or indirectly holds more than 50% of the participation rights or can exercise more than 50% of the voting rights in the foreign company.<sup>32</sup> Section 9D effectively includes a proportional amount of the controlled foreign company’s net income in the resident’s taxable income.

Under section 23I(2), no deduction of expenditure incurred in relation to the use of tainted intellectual property, is permissible to the extent that amounts received or accrued do not constitute a proportional amount of net income that is imputed to the resident as envisaged in section 9D.

**Example 7 – Income not imputed to a South African resident***Facts:*

Alt Corp, a South African company, invented a unique apparatus and sold the patent to Del Corp. Del Corp is a controlled foreign company for purposes of section 9D and is based in Country X. All the shareholders in Del Corp are South African residents.

Del Corp, as owner of the patent, licenced it to Alt Corp which became the “end user” of the intellectual property. In exchange for the use of the intellectual property, Alt Corp made regular royalty payments to Del Corp.

The royalty income of Del Corp formed part of its net income under section 9D which was attributed to its resident shareholders.

Alt Corp wants to claim a deduction under section 11(a) for the cost incurred in making the royalty payments.

<sup>32</sup> See **Annexure** for the full definition of “controlled foreign company”.

**Result:**

Alt Corp can claim a deduction for the expenditure only to the extent that it constitutes a proportional amount of Del Corp's net income included in the residents' taxable income under section 9D. Since this requirement has been met, Alt Corp is entitled to a deduction for the royalty payments.

If no imputation under section 9D were possible, section 23I(2) would have denied a deduction to Alt Corp.

**4.3 Withholding tax on royalties [section 23I(3)]**

Although deductions are prohibited in the circumstances listed in section 23I(2), a portion of the expenditure may be allowed as a deduction if the provisions relating to withholding tax on royalties contained in Part IVA of the Act apply. Withholding tax on royalties is levied under section 49B. The withholding tax on all royalties paid or which became due and payable on or after 1 July 2013 but before 1 January 2015 is calculated at a rate of 12% of the amount of royalties paid. For all royalties paid or which become due and payable on or after 1 January 2015, the withholding tax is calculated at a rate of 15% of the amount of royalties paid.<sup>33</sup>

Section 23I(3)(a) provides that if a withholding tax rate of 10% is payable on royalties, one-third of the expenditure contemplated in section 23I(2) will be allowed as a deduction.

For royalties paid or which become due and payable on or after 1 January 2015, section 23I(3)(b) allows a deduction of half the expenditure relating to royalties if withholding tax is calculated at a rate of 15% of the amount of royalties paid.

Section 23I(3) in its current form became effective on 1 July 2013.<sup>34</sup> From this date to 31 December 2014, section 49B(1) provided for a withholding tax rate on royalties of 12%.

Section 23I(3) provides for a deduction of one-third of the expenditure if tax is withheld at a rate of exactly 10% and one-half if tax is withheld at exactly 15%. On the face of it section 23I(3) does not accommodate the situation in which tax is withheld at a rate which exceeds 10% but is less than 15%, as was the case during the period 1 July 2013 to 31 December 2014 when the rate was 12%. The previous incarnation of section 23I(3), which applied to tax withheld under section 35 before 1 July 2013, accommodated the rate of 12% by referring to tax withheld at a rate of "at least" 10%. Given the history of the provision and the anomalous and insensible result that would follow on a literal interpretation, it is submitted that for the period in question a taxpayer withholding tax at the rate of 12% would be entitled to a deduction of one-third of the expenditure. In this regard, see *Natal Joint Municipal Pension Fund v Endumeni Municipality*, in which Wallis JA stated that in interpreting a statute or contract "a sensible meaning is to be preferred to one that leads to

<sup>33</sup> See section 97(1)(b) of the Taxation Laws Amendment Act 31 of 2013.

<sup>34</sup> Section 23I(3) was amended by section 47(1)(c) of the Taxation Laws Amendment Act 22 of 2012.



insensible or unbusinesslike results or undermines the apparent purpose of the document".<sup>35</sup>

A reduced rate of tax may apply if a tax treaty exists between the states of the contracting parties. For instance, a treaty may reduce a withholding tax rate of 15% to 10% or 5%. Should the rate be reduced to 10% a deduction of one-third of the expenditure will be allowed but if the rate is reduced below 10% no deduction will be allowed.

Should a deduction be allowed under section 23I(3), no deduction will be allowed on the same amount under any other section of the Act.<sup>36</sup>

#### **Example 8 – Allowable deduction under section 23I(3)**

*Facts:*

AB, a South African resident company with a financial year ending on the last day of February, developed an invention and assigned it to CD, a non-resident. CD then licenced the patent to AB in consideration for an annual royalty payment of R600 000. This payment is payable on 1 August each year.

No treaty exists between South Africa and the country in which CD is a resident for tax purposes. Since AB is the end user of the intellectual property, the intellectual property will be regarded as tainted intellectual property.

*Result:*

On 1 August 2016, AB made a royalty payment of R600 000 to CD. This payment was subject to withholding tax at a rate of 15%.

AB is allowed to claim a deduction under section 23I(3)(a), limited to half of the royalty payment in the 2017 year of assessment. The amount that is deductible is thus R300 000.

Had a treaty existed between AB and CD's countries which reduced the withholding tax rate to 10%, the deduction would have been limited to one-third of R600 000 (R200 000).

However, if the rate were reduced to anything below 10%, no deduction would be permitted, since the required rate of 10% would not be met.

<sup>35</sup> 2012 (4) All SA 593 (SCA) at 604.

<sup>36</sup> See section 23B which prohibits double deductions.

**5. Conclusion**

Section 23I disallows a deduction for expenditure incurred for the use of intellectual property when income is shifted between the contracting parties so as to trigger little or no tax.

The section provides for a partial deduction when withholding tax on royalties (Part IVA of the Act) applies.

**Legal Counsel**  
**SOUTH AFRICAN REVENUE SERVICE**

**Annexure – The Law****Section 23I**

**23I. Prohibition of deductions in respect of certain intellectual property.**—(1) For the purposes of this section—

“**end user**” means a taxable person or a person with a permanent establishment within the Republic that uses intellectual property or any corresponding invention during a year of assessment to derive income, other than a person that derives income mainly by virtue of the grant of use or right of use or permission to use intellectual property or any corresponding invention;

“**intellectual property**” 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;

“**tainted intellectual property**” means intellectual property—

- (a) which was the property of the end user or of a taxable person that is or was a connected person, as defined in section 31(4), in relation to the end user;
- (b) which is the property of a taxable person;
- (c) a material part of which was used by a taxable person in carrying on a business while that property was the property of a taxable person and the end user of that property acquired that business or a material part thereof as a going concern; or
- (d) which was discovered, devised, developed, created or produced by the end user of that property, or by a taxable person that is a connected person, as defined in section 31(4), in relation to the end user, if that end user, together with any taxable person that is a connected person in relation to that end user, holds at least 20 per cent of the participation rights, as defined in section 9D, in a person by or to whom an amount is received or accrues—
  - (i) by virtue of the grant of use or right of use or permission to use that property; or
  - (ii) where that receipt, accrual or amount is determined directly or indirectly with reference to expenditure incurred for the use or right of use or permission to use that property;

“**taxable person**” means any person other than—

- (a) a person that is not a resident;
- (b) the government of the Republic in the national, provincial or local sphere contemplated in section 10(1)(a);
- (c) an institution, board or body contemplated in section 10(1)(cA);
- (d) any public benefit organisation as defined in section 30 that has been approved by the Commissioner in terms of that section;
- (e) any recreational club as defined in section 30A that has been approved by the Commissioner in terms of that section;
- (f) any company or trust contemplated in section 37A;

- (g) any fund contemplated in section 10(1)(d)(i) or (ii); or
- (h) any person contemplated in section 10(1)(t).

(2) Other than a deduction allowed in terms of section 11(gC) or a deduction allowed in respect of trading stock, a deduction is not allowed in respect of—

- (a) any amount of expenditure incurred for the use or right of use of or permission to use tainted intellectual property; or
- (b) expenditure the incurral or amount of which is determined directly or indirectly with reference to expenditure incurred for the use or, right of use of or permission to use tainted intellectual property,

to the extent that the amount of expenditure does not constitute income received by or accrued to any other person or to the extent that the amount of expenditure does not constitute a proportional amount of net income of a controlled foreign company an amount equal to which is included in the income of any resident in terms of section 9D.

(3) Notwithstanding any provision of subsection (2) to the contrary, an amount equal to—

- (a) one third of any expenditure contemplated in subsection (2) must be allowed to be deducted if withholding tax on royalties contemplated in Part IVA is payable in respect of that amount at a rate of 10 per cent; or
- (b) one half of any expenditure contemplated in subsection (2) must be allowed to be deducted if withholding tax on royalties contemplated in Part IVA is payable in respect of that amount at a rate of 15 per cent.

### Definition of “resident” in section 1(1)

“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—
    - (aa) for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate during each of the five years of assessment preceding such year of assessment; and
    - (bb) for a period or periods exceeding 915 days in aggregate during those five preceding years of assessment,

in which case that person will be a resident with effect from the first day of that relevant year of assessment: Provided that—

- (A) a day shall include a part of a day, but shall not include any day that a person is in transit through the Republic between two places outside the Republic and that person does not formally enter the Republic through a “port of entry” as contemplated in section 9(1) of the Immigration Act, 2002 (Act No. 13 of 2002), or at any other place as may be permitted by the Director General of the Department of Home Affairs or the Minister of Home Affairs in terms of that Act; and
- (B) where a person who is a resident in terms of this subparagraph is physically outside the Republic for a continuous period of at least 330 full days immediately after the day on which such person ceases to be physically present in the Republic, such person shall be deemed not to have been a resident from the day on which such person so ceased to be physically present in the Republic; or

- (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,

but does not include any person who is deemed to be exclusively a resident of another country for purposes of the application of any agreement entered into between the governments of the Republic and that other country for the avoidance of double taxation: Provided that where any person that is a resident ceases to be a resident during a year of assessment, that person must be regarded as not being a resident from the day on which that person ceases to be a resident: Provided further that in determining whether a person that is a foreign investment entity has its place of effective management in the Republic, no regard must be had to any activity that—

- (a) constitutes—
- (i) a financial service as defined in section 1 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002); or
  - (ii) any service that is incidental to a financial service contemplated in subparagraph (i) where the incidental service is in respect of a financial product that is exempted from the provisions of that Act, as contemplated in section 1 (2) of that Act; and
- (b) is carried on by a financial service provider as defined in section 1 of the Financial Advisory and Intermediary Services Act, 2002 (Act No. 37 of 2002), in terms of a licence issued to that financial service provider under section 8 of that Act;

#### Definition of “connected person” in section 1(1)

“connected person” means—

- (a) in relation to a natural person—
- (i) any relative; and
  - (ii) any trust (other than a portfolio of a collective investment scheme) of which such natural person or such relative is a beneficiary;
- (b) in relation to a trust (other than a portfolio of a collective investment scheme)—
- (i) any beneficiary of such trust; and
  - (ii) any connected person in relation to such beneficiary;
- (bA) in relation to a connected person in relation to a trust (other than a portfolio of a collective investment scheme), includes any other person who is a connected person in relation to such trust;
- (c) in relation to a member of any partnership or foreign partnership—
- (i) any other member; and
  - (ii) any connected person in relation to any member of such partnership or foreign partnership;
- (d) in relation to a company—
- (i) any other company that would be part of the same group of companies as that company if the expression “at least 70 per cent of the equity shares in” in paragraphs (a) and (b) of the definition of “group of companies” in this section were replaced by the expression “more than 50 per cent of the equity shares or voting rights in”;...
  - (ii) . . . . .
  - (iii) . . . . .
  - (iv) any person, other than a company as defined in section 1 of the Companies Act that individually or jointly with any connected person in relation to that person, holds, directly or indirectly, at least 20 per cent of—

- (aa) the equity shares in the company; or
- (bb) the voting rights in the company;
- (v) any other company if at least 20 per cent of the equity shares or voting rights in the company are held by that other company, and no holder of shares holds the majority voting rights in the company;
- (vA) any other company if such other company is managed or controlled by—
  - (aa) any person who or which is a connected person in relation to such company; or
  - (bb) any person who or which is a connected person in relation to a person contemplated in item (aa); and
- (vi) where such company is a close corporation—
  - (aa) any member;
  - (bb) any relative of such member or any trust (other than a portfolio of a collective investment scheme) which is a connected person in relation to such member; and
  - (cc) any other close corporation or company which is a connected person in relation to—
    - (i) any member contemplated in item (aa); or
    - (ii) the relative or trust contemplated in item (bb); and
- (e) in relation to any person who is a connected person in relation to any other person in terms of the foregoing provisions of this definition, such other person:

Provided that for the purposes of this definition, a company includes a portfolio of a collective investment scheme in securities;

### Definition of “controlled foreign company” in section 9D

“**controlled foreign company**” means any foreign company where more than 50 per cent of the total participation rights in that foreign company are directly or indirectly held, or more than 50 per cent of the voting rights in that foreign company are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies: Provided that—

- (a) no regard must be had to any voting rights in any foreign company—
  - (i) which is a listed company; or
  - (ii) if the voting rights in that foreign company are exercisable indirectly through a listed company;
- (b) any voting rights in a foreign company which can be exercised directly by any other controlled foreign company in which that resident (together with any connected person in relation to that resident) can directly or indirectly exercise more than 50 per cent of the voting rights are deemed for purposes of this definition to be exercisable directly by that resident; and
- (c) a person is deemed not to be a resident for purposes of determining whether residents directly or indirectly hold more than 50 per cent of the participation rights or voting rights in a foreign company, if—
  - (i) in the case of a listed company or a foreign company the participation rights of which are held by that person indirectly through a listed company, that person holds less than five per cent of the participation rights of that listed company; or

(ii) in the case of a scheme or arrangement contemplated in paragraph (e) (ii) of the definition of “company” in section 1 or a foreign company the participation rights of which are held and the voting rights of which may be exercised by that person indirectly through such a scheme or arrangement, that person—

(aa) holds less than five per cent of the participation rights of that scheme or arrangement; and

(bb) may not exercise at least five per cent of the voting rights in that scheme or arrangement,

unless more than 50 per cent of the participation rights or voting rights of that foreign company or other foreign company are held by persons who are connected persons in relation to each other;