INTERPRETATION NOTE 120

DATE: 17 May 2022

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

Contents

Preamble

In this Note unless the context indicates otherwise –

- **"CFC"** means controlled foreign company as defined in section 1(1);
- **"connected person"** means connected person as defined in section 31(4);
- **"resident"** means resident as defined in section 1(1);
- **"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**. Unless indicated otherwise, the latest issues of these documents should be consulted.

1. Purpose

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

2. Background

The use of intellectual property belonging to another person normally carries a charge in the form of a royalty. Usually, such payment received will fall within the recipient's gross income and the payor 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 a resident developer. The use of the intellectual property was then granted to a resident company and a royalty was paid for the use of the intellectual property. The connected person typically paid no tax or tax at a very low rate on the royalty income either by virtue of such persons being regarded as exempt institutions or non-resident taxpayers. These types of transactions were designed to reduce the group's overall tax liability in South Africa by having the royalty taxed at a lower tax rate and for the resident company claiming a deduction for royalty payments at the higher tax rate. Section 23I was therefore inserted[1] with the aim of preventing the avoidance of tax.[2]

The Explanatory Memorandum on the Revenue Laws Amendment Bill, 2007, provides the following background to the introduction of section 23I:

> "The disparity in tax rates levied on income between different parties often creates arbitrage opportunities. The purpose of these arbitrage opportunities is to shift income from parties fully within the tax net to parties wholly or partly outside the tax net. In the case of intellectual property, this result is mainly achieved by shifting the intellectual property from a fully taxable party to a party wholly or partly outside the tax net. This shift is usually designed so that the shift triggers little or no tax. After the shift, deductible payments are made from the fully taxable party (now the licensee) to the other party operating wholly or partly outside the South African tax net. In many instances, the tax benefits have no corresponding impact on cash flow as royalty payments are simply

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

[2] Explanatory Memorandum on the Revenue Laws Amendment Bill 2008.

> returned to the licensee-payor in the form of dividends. Meanwhile, the tax deductions for the licensee-payor may be so large as to effectively wipe-out the payor's tax base."

Essentially, section 23I prohibits, subject to certain exceptions, a deduction of any expenditure incurred for the right or permission to use intellectual property qualifying as "tainted intellectual property" and other expenditure which is directly or indirectly related to such expenditure.

3. The law

The relevant sections and definitions are quoted in the **Annexure**.

4. Application of the law

4.1 Introduction

In transactions involving the use of intellectual property, the person legally entitled to use the property is generally obliged to make recurring payments to the owner for the use of that property. These recurring payments are referred to as royalties.

The term "royalty" is defined in section 49A 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; 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".

The definition of a royalty is not, however, restricted to recurring payments and includes once-off payments for the use, right of use or permission to use intellectual property.

With the exception of deductions allowed for the acquisition of intellectual property referred to in section 11(*g*C), a deduction allowed for trading stock and those provided for under section 23I(3) (see **4.4**), section 23I(2) prohibits a deduction of –

- any amount of expenditure incurred for the use of tainted intellectual property;[3] or
- any expenses determined directly or indirectly with reference to the expenditure incurred for the use or right of use of or permission to use any tainted intellectual property,[4]

to the extent that the amount of expenditure does not constitute income[5] received by or accrued to any other person or to the extent that the expenditure does not constitute a proportionate amount of net income of a CFC which is imputed to any resident under section 9D.

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3 Section 23I(2)(*a*).

4 Section 23I(2)(*b*).

5 The term "income" is defined in section 1(1) and means "the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II".

A CFC 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.[6] Section 9D effectively includes a proportional amount of the CFC's net income in the resident's taxable income.

A detailed review on CFCs is beyond the scope of this Note.[7]

Example 1 – Royalty payments received not constituting "income"

Facts:

Z is a South African resident taxpayer who developed certain intellectual property. The intellectual property was subsequently sold to B, a non-resident. B granted a right of use of the intellectual property to Z who made royalty payments to B on an annual basis. Z used the intellectual property to derive income.

Result:

The royalty payments received by B do not constitute income for B. As a result, Z may not claim a deduction for the royalty payments made to B.

Generally, a person who pays someone for the use of tainted intellectual property is not given ownership of that property. Instead, ownership remains with the owner at all times during the agreement as well as upon its termination. Further, a transaction involving the full transfer of ownership of the tainted intellectual property is not for the use, right to use or permission to use the tainted intellectual property even though the use of the item is one of the rights which is transferred.

4.2 Key definitions to the application of section 23I

4.2.1 "Intellectual property"

For property to qualify as "tainted intellectual property", it must meet the definition of "intellectual property".

Under section 23I(1), "intellectual property" means any –

- patent as defined in the Patents Act 57 of 1978. Section 2 of that Act defines a patent as –

  > "a certificate in the prescribed form to the effect that a patent for an invention has been granted in the Republic" including any application for a patent under that Act";

- design as defined in the Designs Act 195 of 1993. Section 1(1) of that Act defines a design as –

  > "an aesthetic design or a functional design";

- trade mark as defined in the Trade Marks Act 194 of 1993. Section 2(1) of that Act states a trade mark as 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

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6 See **Annexure** for the full definition of "controlled foreign company".

7 See paragraph 4.2.1 in Interpretation Note 87 (Issue 3) "Headquarter Companies" for a discussion on CFCs.

> 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 as defined in the Copyright Act 98 of 1978. Section 1(1) of that Act defines copyright as –

  > "copyright under this Act";

- 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;

  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 23I(1), these works will also be regarded as intellectual property as defined under section 23I.

- property or right of a similar nature to those listed in the above bullet points;

  The concept "property of a similar nature" was analysed in *C: SARS v SA Silicone Products (Pty) Ltd.*[8] The court stated 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.

  It was held in ITC 1772 that –[9]

  > "the ordinary grammatical interpretation of the phrase 'property of a similar nature'…means and was intended to mean the acquisition of intellectual property *ie* property which came into existence by the exercise of intellectual powers and to which the law accords the rights and protection of ownership and which may be exploited either by the inventor or originator himself or by others with his leave *ie* by assignment or possibly some other form of transfer."

  A licence is not considered to be "property of a similar nature" since it is merely a right to use intellectual property and does not enjoy any statutory protection;[10] and

- knowledge connected to the use of such patent, design, trade mark, copyright, property or right.

  The knowledge imparted must be connected to the use or application of the intellectual property. As mentioned in the *Silicone* case, common fundamental characteristics must be present. Applying that concept here, the knowledge that is being 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.

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8 [2004] 2 All SA 1 (SCA), 66 SATC 131 at 139.

9 66 SATC 211 at 217.

10 See also AP de Koker & RC Williams *Silke on South African Income Tax* [online] (My LexisNexis: March 2021) in § 8.89.

4.2.2 "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. These requirements are considered below.

(a) Paragraph (*a*)

Under paragraph (*a*), the intellectual property will be regarded as tainted intellectual property if it 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.

Section 31(4) defines a connected person as –[11]

> "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)[12] of that definition must be disregarded".

For the purposes of section 23I, a company will thus be a connected person in relation to another company if it holds at least 20% of the equity shares[13] or voting rights in that company.

Paragraph (*a*) of the definition of tainted intellectual property contains two important terms, that is, "taxable person" and "end user". These terms are explained below.

"Taxable person"

The term "taxable person" is defined in section 23I(1) and means any person other than those persons specifically excluded by the definition of that term. Generally, those persons that have been excluded from the definition of taxable person are those that are exempt from or not subject to South African tax.

A "taxable person"[14] means any *person* other than –

- a non-resident;[15]
- exempt entities or persons mentioned in sections 10(1)(*a*)[16], 10(1)(*c*A) and 10(1)(*t*);[17]
- 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

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11 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".

12 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.

13 The term "equity share" is defined in section 1(1) as "any share in a company, excluding any share that, neither as respects dividends nor as respects returns of capital, carries any right to participate beyond a specified amount in a distribution".

14 Defined in section 23I(1).

15 See **Annexure** for the definition of "resident" in section 1(1).

16 The government of South Africa in the national, provincial or local sphere.

17 For more information on these tax-exempt entities, see the *Tax Exemption Guide for Public Benefit Organisations in South Africa*. See also the **Annexure** for the entities that fall within the ambit of these sections.

- any closure rehabilitation company or trust provided for under section 37A.

The term "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.

"End user"

The term "end user" is defined as a taxable person or a person with a permanent establishment within South Africa that uses intellectual property or any corresponding invention during a year of assessment to derive income. Therefore, exempt taxpayers and non-residents will not fall into the definition of end user and section 23I will not apply to these classes of persons.

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 21 November 2017 (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".

In determining whether a permanent establishment exists, the facts of each case must be considered together with the remaining inclusions and exclusions from the definition which are not reproduced here for the sake of brevity.

The term "end users" excludes persons deriving income *mainly* by virtue of *granting* the use, right of use or permission to use intellectual property or a corresponding invention (generally under a licence or royalty agreement). This means that a person who, for example, uses a patent to manufacture devices for resale and earns an income will be considered to be an "end user" as defined. Conversely, a person (T) who predominately or mainly earns income from granting X the use of the patent which belongs to T instead of actually using such patent, will not qualify as an end user.

In *SBI v Lourens Erasmus (Eiendoms) Bpk*,[18] 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.

The term "corresponding invention" is not defined in the Act. In *Natal Joint Municipal Pension Fund v Endumeni Municipality*[19] the court noted that when interpreting legislation regard must be had to, amongst other things, the context in which the provision appears and the apparent purpose to which it is directed. Section 23I is concerned with prohibiting deductions for specified intellectual property. The meaning of "corresponding invention" must therefore be deduced from intellectual property law.

(b) Paragraph (*b*)

To be considered tainted intellectual property under paragraph (*b*), the intellectual property has to be the property of a taxable person. This means that the intellectual property has to be owned by any person *other* than those specifically excluded in the definition of "taxable person".

Example 2 – Property of a taxable person

Facts:

Q is a South African resident taxpayer who uses intellectual property belonging to R to derive income. R is an approved public benefit organisation as defined in section 30. Q is an "end user" as defined in section 23I.

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. Q will therefore be entitled to deduct expenditure incurred in connection with its right of use of the intellectual property.

The developer of intellectual property who has transferred ownership in the intellectual property to another person will no longer be the owner. Instead, the person who has acquired the intellectual property will be the owner of the property. If the new owner meets all the requirements of the section to be regarded as a taxable person, the intellectual property will be considered tainted.

In the case of a usufruct agreement, a limited real right is conferred on the holder of the usufruct, that is, the usufructuary. In such a transaction, while the right to use the asset is granted to a person, the ownership, or bare *dominium* of the property, does not transfer to the usufructuary. As such, the usufructuary cannot sell the assets, or in this case, intellectual property rights, without the permission of the owner.

[18] 1966 (4) SA 444 (A), 28 SATC 233 at 245.
[19] 2012 (4) SA 593 (SCA) at 604.

Section 23I will therefore apply to bare *dominium* intellectual property schemes (usufruct schemes). These schemes involve the separation of the ownership of intellectual property by a taxable person (the bare *dominium* holder), from the income benefits derived from the granting of the right of use of the intellectual property to a taxable end user. Any tax advantage from the payment of associated royalties to a person who is not the owner of the intellectual property is eliminated through section 23I. No connected person relationship is required.[20]

Example 3 – 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. In other words, the right to receive royalties under the licence agreement with GHI was effectively assigned to JKL. Assume that JKL will not be required to include the amounts received in income for South African tax purposes.

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* while the intellectual property was the property of a taxable person and the end user of the property acquired that business or a material part of it as a *going concern*. 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.

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 that have to be considered.

[20] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2008.

Material part

A material part of the intellectual property must be used by the taxable person. 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.[21] 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. Exactly how the proportion will be measured (for example, value or volume) will depend on the facts and circumstances of the particular case.

Carrying on a business

The intellectual property must be used in the carrying on of a business by the taxable person. The word "business" is not defined in the Act, but "trade" is defined in section 1(1) and includes, amongst other things, business.[22] 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[23] referred to *Joel & Joel v CIR* in which it was stated in relation to the meaning of "carrying on a business" that –[24]

> " 'unless there is something in the Act to the contrary the usual commercial meaning must be given to the words.' "

In determining whether a person is carrying on business, all the surrounding circumstances must be considered.

In Platt v CIR,[25] 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:[26]

> " '[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*,[27] 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.

The question whether a person is carrying on a business must accordingly be determined on the facts of each case.

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21 **www.lexico.com/definition/material** [Accessed 17 May 2022].
22 See Interpretation Note 33 "Assessed losses: Companies: The 'Trade' and 'Income from Trade' Requirements" for a detailed discussion of the trade requirement.
23 (1959) 23 SATC 328 (T) at 330.
24 1922 WLD 29, 33 SATC 106 at 111.
25 1922 AD 42, 32 SATC 142 at 148.
26 (1880) 15 ChD 247 at 258.
27 1920 TPD 288 at 294.

Going concern

In order to be considered tainted intellectual property, an end user of such property must have acquired the business or material part as a going concern. The word "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*[28] 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*,[29] 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 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 4 – Acquiring a business as a going concern

Facts:

ABC and ZED were South African tax paying companies. ABC owned intellectual property which it licensed to ZED. The intellectual property formed a material part of ABC's business. ABC decided to sell its business to ZED as a going concern, excluding the intellectual property rights. ABC and ZED both fell within the definition of "taxable person" in section 23I(1). 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 was obliged to make royalty payments to CHUM Inc.

[28] 2001 (4) SA 1315 (SCA), 62 SATC 451 at 461.

[29] 1982 (2) SA 653 (SECLD) at 657.

Result:

In order for intellectual property to qualify as "tainted intellectual property" as defined, paragraph (*c*) of the definition requires that a material part of 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.[30]

Paragraph (*d*) states 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[31] in relation to the end user [refer to the detailed review of taxable person and end user in **4.2.2(a)**].

This paragraph requires that at least 20% 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 –

- by virtue of the grant of use or right of use or permission to use that property (paragraph (*d*)(i) of the definition of tainted intellectual property); or
- if the 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 (paragraph (*d*)(ii) of the definition of tainted intellectual property).[32]

20% requirement

In paragraph (*d*)(i) of the definition of "tainted intellectual property", the end user together with any taxable person that is connected to that end user must hold at least 20% of the participation rights in a person who receives an amount or to whom an amount accrues by virtue of granting the use, right to use or permission to use intellectual property.

30 Explanatory Memorandum on the Revenue Laws Amendment Bill 2008.
31 See the **Annexure** for the definition of a connected person.
32 See **4.3.1** for a review of the terms used in these paragraphs.

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 with reference 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 sub-paragraph 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 CFCs (see **4.4.2**).

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 been discovered, devised, developed, created or produced through the ingenuity of the end user or taxable person.

Participation rights

Paragraph (*d*) refers to "participation rights" as defined in section 9D.

Section 9D(1) provides 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.

Example 5 – End user holding at least 20% participation rights in the person to whom royalties are paid

Facts:

During the 2021 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 and both companies are taxable persons as contemplated in section 23I(1). SA OpCo is the "end user" of the intellectual property as defined in section 23I(1).

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 the end user of the intellectual property (SA OpCo) and SA OpCo held at least 20% of the participation rights (that is, 30% participation rights) in the person to whom an amount will accrue by virtue of granting the right of use of such intellectual property (that is, 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.

4.3 The prohibition of deductions under section 23I(2)

Section 23I(2) prohibits a deduction of –

- any amount of expenditure incurred for the use of tainted intellectual property [section 23I(2)(*a*)]; or
- any expenses which are determined directly or indirectly with reference to the expenditure incurred 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 of a CFC which is imputed to any resident under section 9D.

4.3.1 The prohibition of a deduction under section 23I(2)(*a*)

Under section 23I(2)(*a*), a deduction is prohibited in respect of any amount of expenditure incurred for the use of tainted intellectual property (see **4.1** and **4.2**).

In order to give effect to section 23I(2), it is often necessary to consider the meaning of terms as used in their context in this section. As such, a brief review is provided below.

"Amount"

Section 23I(2)(*a*) contains 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:[33]

> "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*[34] the court held that even though something cannot be turned into money, this does not mean that it does 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[35] and will be treated in the same manner as a cash royalty.

Expenditure

The word "expenditure" is not defined in the Act. It has, however, been judicially considered.

In *C: SARS v Labat Africa Ltd*,[36] the Supreme Court of Appeal was called upon to consider whether there had been any expenditure when the purchase price for a trademark, which was acquired as part of the acquisition of a business, was settled by the taxpayer issuing its own shares. The court held that irrespective of the fact that the issue of shares for the acquisition of assets amounted to "consideration" given by the company and that the consideration appeared to be fairly valued, there had been no expenditure.

With regard to the word "expenditure", Harms AP noted that –[37]

> "[t]he term 'expenditure' is not defined in the Act and since it is an ordinary English word and, unless context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. … In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter performance may be the same or even more than the value expended".

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33 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".

34 2007 (6) SA 601 (SCA), 69 SATC 205.

35 *Lace Proprietary Mines Ltd v CIR* 1938 AD 267, 9 SATC 349.

36 2013 (2) SA 33 (SCA), 74 SATC 1.

37 74 SATC 1 at 6.

"In respect of"

The words "in respect of" have been considered in many cases. Viviers J in ITC 1340 summarised the position as follows:[38]

> "As was pointed out by Solomon JA in CIR v Crown Mines Ltd 1923 AD 121 at 128, the expression 'in respect of' may be used in various senses, and in each case it is necessary to examine the context in order to ascertain the sense in which it is used. … I need refer only to two of the more recent decisions … SBI v Raubenheimer 1969 (4) SA 314 (A) at 320 (31 SATC 209) and SIR v Wispeco Housing (Pty) Ltd 1973 (1) SA 783 (A) where Ogilvie Thompson CJ said the following at 792:
>
>> 'No doubt the expression "in respect of" must, in certain contexts, be restricted to a direct or causal relationship (cf eg De Villiers v CIR 1929 AD 227 at 229); but, as was pointed out in CIR v Butcher Bros (Pty) Ltd 1945 AD 301 at 320, the expression "in respect of" does not necessarily or invariably indicate such relationship. In that case, it was held to be used in the sense of "in relation to" or "in reference to". (Cf also SBI v Raubenheimer . . .) The expression "in connection with" prima facie extends the ambit of matters comprehended in casu,…'
>
> As appears from all the aforegoing, the context wherein the expressions 'in respect of' and 'in connection with' occur is of vital importance."

Taking the principles from these cases and the purpose of the section into account, "in respect of" is interpreted as requiring a causal connection between the amount received or accrued and the purpose for which it was received.

In the context of section 23I(2), the amount classified as expenditure will not be deductible if it was incurred to acquire tainted intellectual property or if the expenditure was incurred for the use or right of use of or permission to use any tainted intellectual property.

"Received by or accrued to"

The words "received" and "accrued" are not defined in the Act but have received judicial consideration.

In *Geldenhuys v CIR*, Steyn J stated that the words "received by" must mean –[39]

> "received by the taxpayer on his own behalf for his own benefit".

In *WH Lategan v CIR*, Watermeyer J stated the following on the meaning of "accrued":[40]

> "In his Lordship's opinion the words in the Act 'has accrued to or in favour of any person' merely meant 'to which he has become entitled'."

Thus, a royalty includes any amount received by a person on that person's own behalf and for that person's own benefit as well as those amounts that the person is unconditionally entitled to but which have not yet been received.

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[38] (1980) 43 SATC 210 at 212.

[39] 1947 (3) SA 256 (C), 14 SATC 419 at 430.

[40] 1926 CPD 203, 2 SATC 16 at 20. The entitlement principle was confirmed in *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9 at 19.

Under section 23I(2), a deduction will not be allowed to the extent that the amounts of expenditure do not constitute income received by or accrued to any other person. The words "*to the extent*" imply that it may be possible for part of the expenditure to constitute income for the recipient of the royalty. In these cases, a deduction will be denied only on the non-income portion derived by the recipient.

4.3.2 The prohibition of a deduction under section 23I(2)(*b*)

Under section 23I(2)(*b*), expenses determined directly or indirectly with reference to the expenditure incurred for the use or right of use of or permission to use any tainted intellectual property is non-deductible. This section seeks to prevent taxpayers from avoiding tax by stopping transactions in which royalty expenditure is converted into, for example, financial instruments.

In the types of transactions envisioned in section 23I(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.

Example 6 – 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 financial arrangement with a non-resident third party, Z. The arrangement 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 financial arrangement with Z because the payments by X –

- do not constitute income in the hands of Z; and
- are directly or indirectly linked to the tainted intellectual property of X, a taxable person (see **4.2.2** for an explanation of what constitutes tainted intellectual property).

4.4 Exceptions to the general prohibition of deductions under section 23I(3)

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

Section 23I(3) provides that notwithstanding the provisions of section 23I(2) the following proportions of expenditure may be deductible:

(*a*) one third of any expenditure contemplated in Section 23I(2) (refer to the detailed review under **4.3**) 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 Section 23I(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.

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.[41]

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 payable at a rate of 15% of the amount of royalties paid. It appears as if these percentages are absolutes and that on the face of it, section 23I(3) does not accommodate the situation in which tax is withheld at a different rate. This approach was taken during the period 1 July 2013 to 31 December 2014 when section 49B(1) provided for a withholding tax rate on royalties of 12%.

The previous wording 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 insensible or unbusinesslike results or undermines the apparent purpose of the document".[42]

A reduced rate of tax may apply if a tax treaty exists between the contracting states. 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.[43]

Example 7 – Allowable deductions 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.

[41] See section 97(1)(*b*) of the Taxation Laws Amendment Act 31 of 2013. See also Interpretation Note 116 "Withholding Tax on Royalties".

[42] 2012 (4) All SA 593 (SCA) at 604.

[43] See section 23B which prohibits double deductions.

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:

Under section 23I(2) a deduction is impermissible if any amount of expenditure incurred for the use of tainted intellectual property or any expenses which are determined directly or indirectly with reference to the expenditure incurred for the use or right of use of or permission to use any tainted intellectual property, to the extent that the amount of expenditure does not constitute income received by or accrued to any other person.

Provision is, however, made in section 23I(3) for a certain proportion of income to be deducted if a percentage of withholding tax is payable.

On 1 August 2021, 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 2022 year of assessment. The amount that is deductible is thus R300 000.

Had a treaty existed between South Africa and the country in which CD is resident, which reduced the withholding tax rate to 10%, AB's 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.

4.4.2 Prohibition of deductions and CFCs [section 23I(4)]

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. A partial deduction of the expenditure may, however, be allowed if the provisions relating to withholding tax on royalties contained in Part IVA of the Act apply.

Example 8 – Royalty payments and 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 CFC 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.

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. Since the intellectual property was the property of the end user (Alt Corp), it constitutes "tainted intellectual property" as contemplated in section 23I(1).

Paragraph (*d*) of the definition of "tainted intellectual property" includes all intellectual property which was discovered, devised, developed, created or produced by an end user or by a taxable person that is a connected person in relation to the end user. This definition, and in particular the word "developed", is considered to be fairly wide. Given the wide interpretation that could be attributed to this word, the unintended possibility exists that modified or improved intellectual property which was not originally developed, devised or created by the end user or taxable person who is a connected person to the end user could fall within the definition of "tainted intellectual property".

Thus, if a South African company acquires a foreign subsidiary that is rich in intellectual property which is licensed worldwide as well as in South Africa and this foreign subsidiary uses South African-based expertise and infrastructure within the group to enhance the intellectual property, the risk arises that the group may be exposed to section 23I.[44]

As a result, section 23I(4) provides that section 23I(2), which prohibits the deduction of expenditure incurred for the use or right of use or permission to use tainted intellectual property, will not apply if the aggregate amount of taxes which are payable by a CFC for the foreign tax year[45] to a foreign country is at least 67,5% of the amount of normal tax that would have been payable had the CFC been a resident for that tax year.

The aggregate amount of tax payable by a CFC for a foreign tax year must be calculated after accounting for any tax treaty[46] that may apply between the contracting states as well as any credit, rebate or other right of recovery of tax from any sphere of government of any foreign country. Furthermore, any loss in respect of a year other than that foreign tax year or from a company other than that CFC must be disregarded.

[44] Explanatory Memorandum on the Taxation Laws Amendment Bill, 2017.

[45] The term "foreign tax year" in relation to a foreign company is defined in section 1(1) as "any year or period of reporting for foreign income tax purposes by that company or, if that company is not subject to foreign income tax, any annual period of financial reporting by that company".

[46] An agreement for the avoidance of double taxation between South Africa and another country.

5. Conclusion

Save for certain exceptions, section 23I prohibits a deduction of –

- any amount of expenditure incurred for the use of tainted intellectual property; or
- any expenses determined directly or indirectly with reference to the expenditure incurred for the use or right of use of or permission to use any 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 expenditure does not constitute a proportionate amount of net income of a CFC which is imputed to any resident under section 9D.

The effect of section 23I is that 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 is disallowed.

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

Leveraged Legal Products
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)(*c*A);

(*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(*g*C) 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.

(4) Subsection (2) must not apply where the aggregate amount of taxes on income payable to all spheres of government of any country other than the Republic by a controlled foreign company contemplated in that subsection in respect of the foreign tax year of that controlled foreign company is at least 67,5 per cent of the amount of normal tax that would have been payable in respect of any taxable income of the controlled foreign company had the controlled foreign company been a resident for that foreign tax year: Provided that the aggregate amount of tax payable by a controlled foreign company in respect of a foreign tax year of that controlled foreign company must be determined—

(*a*) after taking into account any applicable agreement for the prevention of double taxation and any credit, rebate or other right of recovery of tax from any sphere of government of any country other than the Republic; and

(*b*) after disregarding any loss in respect of a year other than that foreign tax year or from a company other than that controlled foreign company.

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;

(*b*A) 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—

(*a*) 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—

(i) no regard must be had to any voting rights in any foreign company—

(*aa*) which is a listed company; or

(*bb*) if the voting rights in that foreign company are exercisable indirectly through a listed company;

(ii) 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

(iii) 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—

(*aa*) 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

(*bb*) 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—

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

(B) 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; and

(*b*) any foreign company where the financial results of that foreign company are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident;

Relevant exemptions under section 10

10. Exemptions.—(1) There shall be exempt from normal tax—

(*a*) the receipts and accruals of the government of the Republic in the national, provincial or local sphere;

...

(*c*A) the receipts and accruals of—

(i) any institution, board or body (other than a company as defined in the Companies Act, any co-operative, close corporation, trust or water services provider) established by or under any law and which, in the furtherance of its sole or principal object—

(*aa*) conducts scientific, technical or industrial research;

(*bb*) provides necessary or useful commodities, amenities or services to the State (including any provincial administration) or members of the general public; or

(*cc*) carries on activities (including the rendering of financial assistance by way of loans or otherwise) designed to promote commerce, industry or agriculture or any branch thereof;

(ii) any association, corporation or company contemplated in paragraph (*a*)of the definition of “company” in section 1, all the shares of which are held by any such institution, board or body, if the operations of such association, corporation or company are ancillary or complementary to the object of such institution, board or body:

Provided that such institution, board, body or company—

(*a*) has been approved by the Commissioner subject to such conditions as he may deem necessary to ensure that the activities of such institution, board, body or company are wholly or mainly directed to the furtherance of its sole or principal object;

(*b*) is by law or under its constitution—

(i) not permitted to distribute any of its profits or gains to any person, other than, in the case of such company, to the holders of shares in that company;

(ii) required to utilize its funds solely for investment or the object for which it has been established; and

(iii) required on dissolution—

(*aa*) where the institution, board, body or company is established under any law, to transfer its assets to some other institution, board or body which has been granted exemption from tax in terms of this paragraph and which has objects similar to those of such institution, board, body or company; or

(*bb*) where the institution, board or body is established by law, to transfer its assets to—

(A) some other institution, board or body which has been granted exemption from tax in terms of this paragraph and which has objects similar to those of such institution, board, body or company; or

(B) to the State:

Provided further that—

(*a*) where the Commissioner is satisfied that any such institution, board, body or company has during any year of assessment failed to comply with the provisions of this paragraph, he may withdraw his approval of the institution, board, body or company with effect from the commencement of that year of assessment;

(*b*) where the institution, board, body or company fails to transfer, or take reasonable steps to transfer, its assets as contemplated in paragraph (*b*) (iii) of the first proviso, the accumulated net revenue which has not been distributed shall be deemed for the purposes of this Act to be an amount of taxable income which accrued to such institution, board, body or company during the year of assessment contemplated in paragraph (*a*);

...

(*d*) the receipts and accruals of any—

(i) pension fund, pension preservation fund, provident fund, provident preservation fund or retirement annuity fund, or a beneficiary fund defined in section 1 of the Pension Funds Act;

(ii) benefit fund;

...

(*t*) the receipts and accruals—

(i) of the Council for Scientific and Industrial Research;

(ii) of the South African Inventions Development Corporation;

(iii) of the South African National Roads Agency Limited incorporated in terms of section 3 of the South African National Roads Agency Limited and National Roads Act, 1998 (Act No. 7 of 1998);

(iv) . . . . . .

(v) of the Armaments Corporation of South Africa Limited, contemplated in section 2 (1) of the Armaments Corporation of South Africa, Limited Act, 2003 (Act No. 51 of 2003);

(vi) of any company during any period during which all the issued shares of such company are held by the Corporation referred to in subparagraph (v), if the operations of such company are conducted in pursuance of, or are ancillary or complementary to, the objects of the said Corporation;

(vii) of any traditional council or traditional community established or recognised or deemed to have been established or recognised in terms of the Traditional Leadership and Governance Framework Act, 2003 (Act No. 41 of 2003), or any tribe as defined in section 1 of that Act;

(viii) . . . . . .

(ix) of any water services provider;

(x) of the Development Bank of Southern Africa established on 23 June 1983;

(xvi) of—

(*aa*) the compensation fund established by section 15 of the Compensation for Occupational Injuries and Diseases Act, 1993 (Act No. 130 of 1993);

(*bb*) the reserve fund established by section 19 of the Compensation for Occupational Injuries and Diseases Act, 1993 (Act No. 130 of 1993); and

(*cc*) a mutual association licensed in terms of section 30 of the Compensation for Occupational Injuries and Diseases Act, 1993 (Act No. 130 of 1993), to carry on the business of insurance of employers against their liabilities to employees, if the compensation paid by the mutual association is identical to compensation that would have been payable in similar circumstances in terms of that Act;

(xvii) of the National Housing Finance Corporation established in 1996 by the National Department of Human Settlements:

Provided that any entity contemplated in this paragraph must comply with such reporting requirements as the Commissioner may determine.