

BINDING PRIVATE RULING: BPR 082

The guidance contained in this ruling is affected by subsequent law changes and new legislation.

DATE: 19 May 2010

ACT : INCOME TAX ACT, NO. 58 OF 1962 (the Act)

SECTION : SECTION 1 DEFINITION OF "GROSS INCOME" AND SECTIONS 9(1)(b); 10(1)(h) AND 108

SUBJECT : PERMANENT ESTABLISHMENT AND ROYALTIES

1. Summary

This ruling deals with –

- whether the presence of a database replica and a web server in the Republic of South Africa (the RSA) will constitute a permanent establishment of a company that is not a resident;
- whether interest and finance fees payable under loan agreements by borrowers to the company that is not a resident will be exempt from income tax in the RSA; and
- whether the licence fees under the User Agreements will be business profits and not royalties.

2. Relevant tax laws

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

In this ruling legislative references to sections and Articles are to sections of the Act and Articles of the OECD Model Tax Convention on Income and on Capital (OECD Model) applicable as at 10 January 2010 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act and the OECD Model.

This ruling has been requested under –

- section 1 definition of "gross income";
- section 9(1)(b);
- section 10(1)(h);
- section 108; and

- Articles 5 and 7 of the OECD Model for a Tax Convention normally entered into between contracting states for the prevention of double taxation (DTA).

3. Parties to the proposed transaction

The Applicant: A company that is not a “resident” as defined in section 1 and is a partner to Partnership 1

The Co-Applicant: A company that is not a “resident” as defined in section 1 and is a partner to Partnership 2

Other parties

Partnership 1: SA Partnership established between the Applicant and SA Company 1

Partnership 2: SA Partnership established between the Co-Applicant and SA Company 2

The Partnerships Partnership 1 and Partnership 2

SA Company 1: Partner to Partnership 1

SA Company 2: Partner to Partnership 2

The Users: Users of the computer software programme (software programme) to be provided by Partnership 1

4. Description of the proposed transaction

Partnership 1 will be established for the purpose of providing software programmes to the Users who wish to expand their businesses in a specified industry. Partnership 1 will generate income from providing the software programme needed by the Users to manage their businesses. In order to encourage the Users to enter this specified industry, the necessary capital will be lent to the Users by Partnership 2. Partnership 2 will generate income from finance charges on the loans granted to the Users.

The Users will, therefore, commence and conduct their businesses, and maintain their customer base, using the software programmes, know-how and loan capital provided by the Partnerships. The Users will pay certain fees under a User Agreement including, *inter alia*, software programme usage fees and ongoing connection fees to Partnership 1.

The Partnerships will be organized as unincorporated partnerships by contract (a Partnership Agreement) under the Roman Dutch law principles retained as the common law of South Africa. In broad terms –

- the Applicant will licence the software programmes to Partnership 1;
- SA Company 1 will provide 'ground support', develop the market and provide support the Users of the software programmes; and
- Partnership 2 will provide the necessary funding needed by the Users to use the software programmes.

Pursuant to the proposed Partnership Agreement between the Applicant and SA Company 1:

The Applicant will be required to –

- grant a perpetual, exclusive and transferable licence to use, modify and develop the software programmes within the RSA, Namibia, Lesotho and Swaziland (the territory). Delivery will comprise supply of a copy of the source code. At delivery the software programmes will conform to RSA regulatory requirements;
- provide existing systems, procedures and intellectual property associated with the operation of the software programmes;
- provide initial training, train the trainer, training to SA Company 1; and
- provide support as reasonably required for the pilot of the software programmes.

SA Company 1 will be required to –

- facilitate access to initial and future distribution networks within the territory for the purposes of commercialising the software programmes; and
- provide intellectual property associated with the commercial environment and a gateway into the business community in the territory.

Nature of Partnership 1's business

The business of Partnership 1 will principally involve supporting existing Users and locating new Users.

The Partnerships will have no 'shop front'

The Partnerships will have no 'shop front' in the RSA for the purposes of carrying on their businesses. The Partnerships will merely support the Users.

General Manager & employees

SA Company 1 will make available to Partnership 1 the services of a General Manager and a number of employees.

The Partnerships will own no tangible assets

The Partnerships will themselves, own no tangible assets.

The Partnerships' intangible assets

The only intangible assets of the Partnerships will be bank accounts held in the RSA and debts such as interest due by the Users in respect of loan accounts and certain fees due by Users under the User Agreement including, *inter alia*, software programme usage fees and ongoing connection fees as well as licence fees.

Signature of agreements

All the necessary agreements will be signed by the Applicant and the Co-Applicant in their respective countries of residence, and thus outside the RSA.

SA Company 1 and SA Company 2 will not be authorized to sign any documentation on behalf of the Applicant or the Co-Applicant.

The software programmes

The software programmes will have three components, the Database Server, the Processing Server, and the Web Server. These Servers will be set up as follows:

The Database Server will be owned by the Applicant and located in the country of residence of the Applicant and will store and retrieve all records of the business transactions of the Users entered into with the clients of the Users.

The Processing Server will be located in the country of residence of the Applicant and will perform batch processing on data to produce financial transactions.

- The Processing Server will access the Database Server to retrieve and process the necessary transaction and store transaction information.
- The Processing Server will submit transactions to the relevant South African financial institutions.

The Web Server will be located in the RSA and will be owned and operated by SA Company 1.

- The Web Server will provide access to the software programmes *via* a collection of web pages. The Web Server will access the Database Server to retrieve information, store any new data, allow the Users to process transactions, view customer details, view historic transactions and view and print reports.

A Database Replica will be located in the RSA and will be owned and operated by SA Company 1.

The Database Replica will be a static copy of data maintained on the primary Database Server. It will be updated (replicated) once per day, by receiving new data and transactions resulting from batch processing in the country of residence of the Applicant by the Processing Server.

The Database Server replication is an accepted, widely-used, technology for physically distributing data for performance benefits and fault-tolerance.

As a result of the hardware design, all the processing, data storage and back-up will be done in the country of residence of the Applicant, so it will be close to the technical support required to maintain and develop the software programmes.

The Applicant and SA Company 1's respective contributions to Partnership 1

The Applicant will make its contribution 'up-front' by investing funds to develop the software programmes and get the products up and running.

SA Company 1 will make its contribution by being responsible for the 'on the ground' operation of the software programmes.

The income of Partnership 1 will be shared amongst the partners on an equal basis.

The Co-Applicant and SA Company 2's respective contributions to Partnership 2

The Co-Applicant and SA Company 2 will agree to borrow monies and lend monies to the Users on a 50/50 basis.

The income of Partnership 2 will be shared amongst the partners on an equal basis.

5. Conditions and assumptions

This ruling is made subject to the conditions and assumptions that SA Company 1 and SA Company 2 will be independent agents in relation to the Applicant and the Co-Applicant.

6. Ruling

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

- The Applicant and the Co-Applicant will not be carrying on a business at or through a permanent establishment located in the RSA, and will therefore not be taxable in the RSA on their respective share of partnership profits.

- The presence of the Web Server and the Database Replica in the RSA will not constitute a permanent establishment of the Applicant or of the Co-Applicant.
- Interest and finance fees payable by the Users to Partnership 2 under the loan agreements will be exempt from income tax in the RSA in the hands of the Co-Applicant.
- The fees payable by Users to Partnership 1 under the User Agreements including *inter alia*, software programme usage fees and ongoing connection fees as well as licence fees will be business profits and not royalties and therefore will be exempt from income tax in the RSA in the hands of the Applicant.

7. Period for which this is valid

This binding private ruling is valid for a period of five years (5) from the date of this ruling.

8. Other

Value-Added Tax in terms of the Value-Added Tax Act, No. 89 of 1991 has not been considered.

Issued by:

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