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South African Revenue Service
Private Bag X923
Pretoria
0001

BY E-MAIL: policycomments@sars.gov.za

Dear Mr/Mrs

PUBLIC COMMENTS ON THE DRAFT INTERPRETATION NOTE: WITHHOLDING TAX ON ROYALTIES

INTRODUCTION

1. We set out below, on behalf of the South African Institute of Chartered Accountants ("SAICA") National Tax Committee, our comments and submissions to the South African Revenue Service ("SARS") in relation the Draft Interpretation Note ("Draft IN") relating to withholding tax on royalties, which provides guidance on the interpretation and application of sections 49A to 49H of the Income Tax Act No 58 of 1962 ("the Act").

2. We would like to thank SARS for the opportunity to participate in providing input on the Draft IN.

3. Our submission is attached in Annexure A. We have deliberately tried to keep our submission as concise as possible, which does mean that you might require further clarification. Should you require any further clarification on any of the matters raised please do not hesitate to contact us.

Yours sincerely

Tracy Brophy
Chairperson: National Tax Committee
The South African Institute of Chartered Accountants

Pieter Faber
Senior Executive: Tax

ANNEXURE A

COMMENTS

Background (Clause 2)

Problem statement

1. In Clause 2 of the Draft IN, it states that:

   "The withholding tax on royalties applies to royalties paid by a resident to a non-resident for the use of intellectual property belonging to the non-resident."

2. The statement that the withholding tax on royalties applies to royalties paid by a resident to a non-resident is incorrect. The withholding tax on royalties applies to royalties, as specifically defined in section 49A of the Act, paid to a non-resident, whether such payments are made by a resident or a non-resident, provided that the other requirements for the imposition of the tax are met.

3. *Submission:* In light of the above, we recommend that the sentence contained in clause 2 is amended as follows:

   "The withholding tax on royalties applies to royalties paid by a resident to a non-resident for the use of intellectual property belonging to the non-resident and the imparting of scientific, technical, industrial or commercial knowledge or information by the non-resident as well as the rendering of assistance or services by the non-resident in connection with the application or use of such knowledge or information." (Underlining indicates new text).

Section of the Acts that are quoted in the Annexure to the Interpretation Note

Problem statement

4. In the Annexure to the Draft IN, only sections 49A to 49H and the "resident" definition contained in section 1(1) of the Act were included.

5. However, section 23I and section 9(2)(c),(d),(e) and (f), which are integral to sections 49A to 49H, were not included.

6. *Submission:* In light of the above, we recommend for the sake of completeness and ease of reference that sections 23I and 9(2)(c),(d),(e) and (f), are also included in the Annexure to the Draft IN.

Meaning of "amount received or accrued"

Problem Statement

7. The definition of a "*royalty*" provides that an amount must be received or accrued. Although the Draft IN includes the various judicial considerations relating to the meanings of these terms, there is no mention or guidance on the payment of a royalty that is bundled with other amounts such as services into a bundled or composite fee.

8. *Submission:* SARS to provide clarity on how royalties bundled with other amounts into a bundle or composite fee will be treated.

Problem Statement

9. The Draft IN notes that "*entitlement*" will fall within the ambit of "*accrued*" as per the *Lategan* case.

10. However given the subsequent judicial approach (e.g. *CIR v Delfos 1933 AD 242 at 251; Ochberg v CIR1933 CPD 256; Hersov's Estate v CIR 1957 (1) SA 471 (A)*) to clarifying "*accrued*" as meaning "*due and payable*" and not just due for example where payment the royalty may still be subject to obligations and may therefore not be due and payable.

11. *Submission:* It is proposed that clarification should be added to clarify that accrues means "entitlement" but also refers to where the royalty *"has become due and payable"* as held in judicial clarification. .

Intellectual property definition (Clause 4.1.2(d))

Problem statement

12. Clause 4.1.2(d) of the Draft IN, on page 5, provides insight as to the meanings ascribed to the following words, having regard to their definitions as contained in the respective Acts:

- Patent;
- Design; and
- Trademark.

13. The intellectual property definition contained in section 23I also encompasses a "copyright as defined in the Copyright Act". However, the "copyright" definition as contained in the Copyright Act has not been considered in the Draft IN.

14. *Submission:* For the purpose of completeness, it is recommended that the "copyright" definition, as contained in the Copyright Act, is included in the Draft IN, as is the case for the other words (patent, design and trademark).

Problem statement

15. Clause 4.1.2(d) of the Draft IN provides guidance in relation to the various paragraphs that make up the definition of "intellectual property" as contained in section 23I. However, no insight was provided in relation to paragraph (g) of the definition of intellectual property, which for ease of reference states:

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

16. *Submission:* In light of the above, it is recommended that the clause 4.1.2(d) is expanded to consider paragraph (g) of the definition of intellectual property. In particular, we recommend that examples are provided and the differences highlighted (if any) between paragraph (g) and paragraph (b) of the royalty definition contained in section 49A of the Act which, for

ease of reference, specifically states:

"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."

Royalty definition paragraph (b): Scientific, technical, industrial or commercial knowledge or information (Clause 4.1.2(e))

Problem statement

17. In clause 4.1.2(e), the Draft IN provides guidance on paragraph (b) of the "royalty" definition which specifically states that the imparting of scientific, technical, industrial or commercial knowledge or information is *inter alia* considered a royalty for royalty withholding tax purposes.

18. Following the Oxford Dictionary meaning of the word "impart", clause 4.1.2(e) goes on to state the following:

"Thus, a payment received by or accrued to a person for imparting (for example through instruction or teaching) scientific, technical, industrial or commercial knowledge or information will be considered a royalty."

19. This statement is very wide and in the context should only encompass intellectual property, given that paragraph (b) of the "royalty" definition should be read in conjunction with paragraph (a).

20. *Submission*: In light of the above, we recommend that the sentence contained in clause 4.1.2(e) is amended as follows:

"Thus, a payment received by or accrued to a person for imparting (for example through instruction or teaching) scientific, technical, industrial or commercial knowledge or information in relation to such intellectual property as envisaged in paragraph (a) of the royalty definition, will be considered a royalty." (Underlining indicates new text).

Problem Statement

21. In clause 4.1.2(e), the Draft IN deals with the meaning that should be ascribed to "impart". The correct and accurate interpretation of this term is crucial as any amount that is received or accrued in respect of the imparting or undertaking to impart any scientific, technical, industrial or commercial knowledge or information will give rise to a liability for the royalty withholding tax.

22. As mentioned in the Draft IN, the Oxford Dictionary defines "impart" as making (information) known. Although not binding but only persuasive in a South African context, an Indian Income Tax Appellant Tribunal[1] ruled on the meaning of "to make available" in the context of the treaty royalty article and equated it to impart.

[1] Sandvik AB, C/o Sandvik Asia Private Limited v DDIT, Pune, ITA No 47/PN/2013

23. The Indian Income Tax Appellant Tribunal stated that the technical or consultancy service rendered should be of such a nature that it "makes available" to the recipient technical knowledge, know-how and the like. The service should be aimed at and result in transmitting technical knowledge so that the payor of the service could derive an enduring benefit and utilise the knowledge or know-how on his own in future without the aid of the service provider.

24. *Submission*: In light of the above, we recommend that the discussion on the meaning of "impart" be expanded upon so that it is clear that in order for scientific, technical, industrial or commercial knowledge or information to be "imparted", the relevant information or knowledge must be provided in such a manner that the scientific, technical, industrial or commercial knowledge or information remains with the recipient of such information or knowledge. Before such knowledge or information can be regarded as being imparted, such knowledge or information should be absorbed by the recipient so that the recipient can use and apply the knowledge and information in the future without depending on the provider. In other words a distinction should be clearly made between "know how" and" show how".

25. In addition, on the basis that no distinction is currently made by SARS between the concepts of "know-how" and "show-how", it is recommended that SARS provide detailed guidance on the interpretation and treatment of these terms.

The meaning of "the use or right of use of or permission to use any intellectual property"

Problem statement

26. Section 49A of the Act states that a royalty means any amount that is received or accrues in respect of the use or right of use of or permission to use any intellectual property as defined in section 23I.

27. In the context of a copyright, a problem arises when there is a sale of an integrated product such as an outright sale of hardware, which includes software. In Article 12(1) of most double taxation agreements ("DTAs"), royalties arising in South Africa and beneficially owned by a resident of the other contracting state, will only be taxable in that foreign country. The DTAs generally define a royalty as:

"…payments of any kind received as consideration for the use of, or the right to use, any copyright…"

28. In relation to software, the OECD Commentary to the Model Tax Convention ("the MTC Commentary") draws a distinction between the use of the copyright in the computer program, and the use of the computer program that embodies the copyright. The MTC Commentary proceeds to state that payments in respect of the use of the copyright will constitute a royalty, whilst payments for the use of a computer program will be business profits for the purposes of Article 7 of the DTA.

29. Submission: In light of the above, we request that SARS provides further clarity and guidance on the interpretation of *"the use or right of use of or permission to use any intellectual property as defined in section 23I".*

Payment of a royalty (clause 4.4)

Problem statement

30. In clause 4.4 of the Draft IN, it highlights (having regard to section 9(2)(c),(d),(e) and (f) of the Act), when royalty amounts are considered to be sourced within South Africa. In particular, clause 4.4 states that a royalty is considered to be South African sourced in *inter alia* the following scenarios:

"Constitutes a royalty that is attributable to an amount incurred by a person that is a resident, unless the royalty is attributable to a permanent establishment which is situated outside South Africa; and

Is attributable to an amount incurred by a person that is a resident and is received by or accrues to this person for 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, unless the amount received or accrued is attributable to a permanent establishment which is situated outside South Africa."
(Underlined text indicates own emphasis).

31. Besides quoting section 9(2)(c),(d),(e) and (f), no further insight is provided in this regard. In particular, the Draft IN does not highlight who the permanent establishment is in relation to, namely the resident payer or the non-resident recipient.

32.	*Submission:* In light of the above we recommend that the Draft IN is amended to include further guidance in relation to section 9(2)(c),(d),(e) and (f) of the Act. In particular, having reference to section 9(2)(c) and (e), the Draft IN should highlight who the permanent establishment is in relation to (i.e. the resident payer or the non-resident recipient).

Problem Statement

33. In clause 4.4 of the Draft IN, the payment of the royalty is dealt with. It provides what amounts are subject to withholding tax, the rate at which the withholding tax should be withheld and who is subject to the withholding tax.

34.	*Submission:* It is recommended that SARS makes is explicitly clear in this section that the withholding tax has no connection or linkage with whether a royalty is deductible in terms of section 11(a) or not.

Exemptions under section 10(1)(l) (Clause 4.5.1)

Problem statement

35. In clause 4.5.1 of the Draft IN on page 9, it states the following:

"Since withholding tax on royalties is a final tax, an annual return of income does not have to be submitted as long as the royalty amount is the sole source of income from a South African source. Should the foreign person derive other income from a South African source, a return of income will have to be submitted." (Underlined text indicates own emphasis).

36. Having regard to the recent public notice[2] issued by the Commissioner highlighting the persons who are required to furnish returns, paragraph 2(b) stipulates that non-resident corporates, trusts, or other juristic persons must furnish a South African income tax return if the non-resident:

- Carried on a trade through a permanent establishment in the Republic;
- Derived income from a source in the Republic; or
- Derived any capital gain or capital loss from a source in the Republic.

37. In light of this, the above mentioned statement made in clause 4.5.1 of the Draft IN is technically incorrect.

38. *Submission:* In light of the above, we recommend that clause 4.5.1 (as highlighted in bold above) is amended, since taxpayers should not be required to rely on Interpretation Notes to determine when a return should be furnished, as it is the duty of the Commissioner to notify taxpayers, via public notice, in terms of section 66 of the Act when returns should be furnished. In addition, in this instance, the Commissioner has already issued a public notice (as footnoted above) which overrides the statement in the Draft IN.

Interaction between section 10(l) and Part IVA of the Income Tax Act

Problem statement

39. The analyses of the transaction below demonstrates an instance where service fees received by non-residents comprise royalties for domestic South African law purposes, but do not comprise royalties for purposes of the application of DTAs, which are based on the Organisation for Economic Co-operation and Development ("OECD") Model Taxation Agreement ("Model DTA"):

- A non-resident company ("Foreign Co") enters into an agreement ("the Agreement") with a South African company ("SA Co") for:
  - The licensing of software for use in South Africa; and
  - The provision of services to SA Co (i.e. the employees of the Foreign Co is to train employees of SA on the use of the software and assist them with the implementation of the software).
- These services are to be rendered by employees of Foreign Co, who are:
  - permanently located at its head office abroad; as well as
  - temporarily located in SA at the premises of SA Co.
- The employees of Foreign Co are located at the premises of SA Co, for the purpose of rendering the services described above, for a period exceeding 183 days in aggregate during a 12 month period, and for the purposes of this discussion it is assumed that

[2] Government Notice No. 671, dated 3 June 2016, as found in the South African Government Gazette issue number 400041

their presence has created a permanent establishment ("PE") of Foreign Co in South Africa.

- A DTA has been concluded between the country of residence of Foreign Co and South Africa, which is based on the Model DTA.

- The "economic ownership" of the software and related "know-how" were not transferred to South Africa, but remained in the country of residence of Foreign Co, where the relevant software programs, instruction manuals, user guides and related information were developed.

40. Practical difficulties arise in respect of the application for relief under a relevant DTA, where, such amounts are subject to royalty withholding tax (and exempt from normal tax) because, although the receipt of the service fees is attributable to an South African PE of the foreign recipient, the intellectual property or knowledge (in respect of which the royalty/service fee is paid) is not effectively connected with that PE.

41. This is, in essence, because royalty withholding tax is levied on a "gross basis" (i.e. will be levied on the royalty/service fee before taking deductions into consideration), whilst normal tax is levied on taxable income, as defined (i.e. is levied on receipts after taking allowable expenditure and deductions into consideration). The Model DTA stipulates that in determining the profits of a PE, there must be allowed, as a deduction, expenses which are incurred for the purposes of the PE.[3] In theory, therefore, the Model DTA requires in such instance, that royalty withholding tax should only be leviable on so much of the gross amount that will remain after the deduction of attributable qualifying expenses.

42. Furthermore, it should be noted that royalty withholding tax is only imposed where the recipient is non-resident, whilst South African residents would generally be subject to normal tax in respect of the receipt of similar service fees. In this regard, the Model DTA[4] stipulates that South Africa may not tax a South African PE of a resident of the other Contracting State in a manner that is less favourable than the manner in which a South African resident, which carries on the same activities, would be taxed. Consequently, since the foreign recipient is prejudiced by the fact that the service fees which are attributable to its South African PE is subject to royalty withholding tax, and not to normal tax, as would have been the case had Foreign Co been a South African resident, treaty relief should be available to alleviate this prejudice in terms of the non-discrimination article of the relevant DTA.

43. As it is trite law that a DTA cannot impose a tax liability (i.e. an amount which is exempted from normal tax in terms of domestic South African law, cannot be subjected to normal tax by virtue of the application of the provisions of the Model DTA). It is considered that the correct application of the DTA would require that the royalty withholding tax be withheld on a "net basis" (i.e. be levied on the service fee after taking deductions into consideration).

44. Currently, no administrative processes are available to the South African recipient of the royalty/service fee to access the available DTA relief described above.

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[3] Article 7(3) of the Model DTA
[4] Article 24 of the Model DTA

45. *Submission:* Practical guidelines should be provided and administrative processes put in place in the Draft IN, in order to enable the recipient of the royalty/service fee to effectively access the available DTA relief described above.

46. Alternatively, it is proposed that legislative amendments will be required in order to prevent the prejudice in terms of the non-discrimination articles of the DTAs.

Release of obligation to withhold tax (Clause 4.7)

Problem Statement

47. Clause 4.7.of the Draft IN reiterates what is stated in section 49E(2)/(3) which states that in order for an exemption or reduced rate to be applied to the royalty payment, a declaration must be submitted to SARS by the date set by the payor of the royalty. If the payor of the royalty does not set a date, the submission must be made by the date of the payment of the royalty.

48. *Submission:* It is recommended that SARS provide guidance on the timing of *"by a date set by the person paying the royalty"*, i.e. providing clarity whether the declaration must be made before the royalty is paid.

Reduction of the withholding rate (Clause 4.8)

Problem Statement

49. In clause 4.8 of the Draft IN, the reduced royalty withholding tax rates and the compliance obligations are discussed. However, there is no mention or guidance relating to royalties which are non-arm's length.

50. In addition, as a general observation, in order to access the reduced withholding tax rate in a DTA, the person receiving the royalty must be the beneficial owner of that royalty. Nowhere in the Draft IN is mention made of or guidance provided relating to the term "beneficial ownership".

51. *Submission:* It is recommended that SARS provide guidance on the treatment of royalties paid between related parties that are not at arm's length.

52. In addition, it is recommended that SARS provide clarity on the term "beneficial owner" in a DTA context.

Payment of the withholding tax (Clause 4.10)

Problem Statement

53. The waiving of the obligation to withhold or to withhold at a reduced rate in clause 4.7 and 4.8 of the Draft IN, respectively, do not refer to instances where it may be "deemed" that payment of royalties have been made per section 49B(2), which has two different concepts of paid.

54. Therefore does "*date of payment*" in section 49E refer to actually paid or due and payable?

55. Similarly, reference should be made to deemed payments under clause 4.10 of the Draft IN.

56.	*Submission*: It is submitted that SARS should clarify whether both concepts of paid applies throughout Chapter 2 Part IV A and if it does, then references to "payment" should be extended to "deemed payment" i.e. due and payable.

Refund of withholding tax on royalties (Clause 4.11)

Problem Statement

57. Although section 49G of the Act provides for the refund of withholding tax on royalties and clause 4.11 of the Draft IN provides clarity and guidance on how this is achieved, there is no mention or guidance relating to instances where a royalty is withheld incorrectly but a declaration form was still submitted as required by the beneficial owner.

58.	*Submission:* It is recommended that SARS provide guidance on how such a refund can be claimed.

General typos (Clause 4.5.1 and clause 5)

Problem statement

59. The following typing errors were identified (Bold brackets indicates a deletion of text and underlined text indicates new text):

- Clause 4.5.1 the footnote 32 states "section 49D(1)" which should be amended to "section 49D**[(1)]**"
- Clause 5 the first bullet states "enable the taxpayer to observe the requirements of a tax act" which should be amended to "enable the taxpayer to observe the requirements of a tax **[a]**Act".

60.	*Submission:* In light of the above, we recommend that the suggested amendments are effected in the Draft IN.

General comments

Problem statement

61. We note that the following points have not been addressed at all in the Draft IN:

- In relation to withholding tax certificates, clarity is required on how these are obtained and whether copies of withholding tax certificates may be requested from SARS;
- The application of a DTA, especially in cases where the definition of a royalty, as contained in a DTA, differs from the definition contained in section 49A of the Act.
- Given that the "royalty" definition *inter alia* refers to: *"rendering of assistance or service in connection with the application or use of such knowledge or information"* (underlined text indicates own emphasis), guidance is required on the application in the case of "services";

- Guidance on the interplay between the royalty withholding tax section and the non-resident, South African sourced, services reportable arrangement[5] (as contained in the public notice which has been footnoted below) requirement should be included.

- The difference between a royalty and a service fee is not addressed in the draft IN and it is accordingly requested that SARS provides clarity and guidance on how to differentiate between such payments;

- We understand that royalty withholding tax must be withheld on the earlier of the date the royalty is paid, or the date that the royalty becomes due and payable. We therefore request SARS to provide guidance on instances where a royalty became due and payable, and therefore withholding tax was withheld, but was ultimately written off and never paid to the beneficial owner.

62.	*Submission:* In order to make the Draft IN as effective as possible in assisting in the interpretation of what constitutes a "royalty" and how to apply the withholding tax regime in that regard, we recommend that the above mentioned points are appropriately considered when finalising the Draft IN.

Payment of RWT and submission of returns

Problem statement

63. The Draft IN states that a Return for Withholding Tax on Royalties (form WTR01) must be completed and submitted for each royalty payment made and that the royalty withholding tax withheld be paid *inter alia* via eFiling. However, it is currently not possible to either submit WTR01 forms or make payment of royalty withholding tax via eFiling.

64.	*Submission:* The eFiling platform should be updated in order to enable these functionalities.

[5] Government Notice No. 140, dated 3 February 2016, as found in the South African Government Gazette issue number 39650