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Defining a royalty from a South African perspective for the purposes of the South African Income Tax Act and the South African application of its Double Tax Treaty network

by
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DECLARATION

I, Ryan Buckley, hereby declare that the work on which this research paper is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

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ABSTRACT

The word “royalty” is used in South Africa’s Income Tax Act No. 58 of 1962 (“ITA”) at various points. Although there is a general understanding on the meaning of a royalty, there is no official definition for this term which can be used throughout the ITA. Section 35 of the ITA provides the strongest guidance of what a royalty is. However, this section applies to royalties and similar payments.

The OECD DTA contains a definition for royalties which is substantially similar to the wording of section 35. However, the OECD DTA does not specifically include show-how (which is included in section 35). Accordingly, there appears to be a misalignment.

Based on the commentary to the OECD DTA, “mixed contracts” (i.e. contracts which include both imparting of know-how and show how) do exist and will form part of imparting know-how (and therefore included in the definition in the OECD DTA) if the imparting of know-how is “by far the principle purpose” of the contract. However, determining which part of the mixed contract is “by far the principle purpose” is fact specific and each case would need to be considered based on its own set of facts.

The wording of section 35 also includes amounts for “property or rights of a similar nature” (which are not included in the OECD DTA definition) and one would need to consider whether a receipt would be for the use of such “property or right of a similar nature”.

The majority of literature points to a restrictive interpretation for this term (i.e. the items need to be similar to the specifically identified property in section 35). In this regard, the property in issue needs to have characteristics common to all the identified property. The one characteristic that is common to all the specifically identified property is that those properties are derived from a creative effort. Therefore, an IP not listed in section 35 which was derived from a creative mind would constitute a “property or right of a similar nature” as used in section 35. However, this would also be fact specific and each case would need to be determined on its specific set of facts.
It is submitted that an official definition for “royalties” should be formulated for the purposes of the ITA. Using the wording already contained in the ITA as well as definitions from other sources, the official definition should consist of two parts, namely:

1. amounts received for the use of an IP; and

2. amounts received for the impartation of knowledge (know-how), as well as for services rendered in connection with that knowledge (show-how).

This definition should be in line with the wording of section 35. However, due to the uncertainty created by the misalignment between section 35 and the OECD DTA definition, it is submitted that the official definition should be aligned with the OECD DTA definition and if it is the intention of legislature to specifically include show-how and “property or rights of a similar nature”, the ITA should specifically state as such in the relevant provision.
### ABBREVIATIONS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>CFC</td>
<td>Controlled Foreign Companies</td>
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<td>DTA</td>
<td>Double Tax Agreement</td>
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<tr>
<td>IP</td>
<td>Intellectual Property</td>
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<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>SARS</td>
<td>South African Revenue Service</td>
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<tr>
<td>The ITA</td>
<td>Income Tax Act, 58 of 1962</td>
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<tr>
<td>WIPO</td>
<td>World Intellectual Property Organisation</td>
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<tr>
<td>Interpretation Act</td>
<td>Interpretation Act 33 of 1957</td>
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<td>UN</td>
<td>United Nations</td>
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<tr>
<td>WHT</td>
<td>Withholding tax</td>
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<td>SA</td>
<td>South Africa</td>
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<td>FBE</td>
<td>Foreign Business Establishment</td>
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CHAPTER 1: INTRODUCTION

1.1. INTELLECTUAL PROPERTY

1.1.1. The meaning of intellectual property and its importance

Intellectual Property (“IP”), also referred to as an intangible asset, forms an integral part of many businesses today. Broadly speaking, intangible assets are assets of a company with no physical substance. They are used by businesses to, *inter alia*, generate income and improve their marketability. Trademarks, patents and copyrights are typical examples of intangible assets. These various types of intangible assets will be discussed in more detail in later chapters.

Businesses worldwide have recognised the importance of their intangible assets. The World Intellectual Property Organisation (“WIPO”), a specialised agency of the United Nations which promotes the protection of IP, states the following on their website:

"The importance of [...] intangible assets in business may be gleaned from any of the market leaders. A quick review of major companies, such as Philips, Sony, Samsung, Pfizer, Proctor & Gamble, Xerox, IBM, Ford, The Home Depot, reveals that much of the wealth of these companies is encapsulated in their intangible assets [...] In fact, a 2002 survey of the Fortune 500 companies estimated that anywhere from 45% to 75% of the wealth of individual companies comes from their Intellectual Property Rights".¹

Accordingly, the importance of IP’s in today’s business should not be underestimated and the efficacy of its use may be the difference between a company’s success or failure. Consequently, such focus by businesses would generally lead to significant financial investment, which would generally, in turn, result in additional income streams (e.g. royalties, licence fees) and this would attract the attention of revenue authorities throughout the world.

1.1.2. Acquiring IP

There are many ways in which IP can be acquired. One method of acquiring IP would be to purchase it from the current owner. However, this may not always be possible.

It is more common for IP to be sold between related parties. For example, a company within a group of companies may sell its IP to another company within the group for the purpose of, *inter alia*, improving the operational efficiency of the group as a whole. Another common example (and possibly the most common example) is for a group of companies to transfer its IP to companies situated in a low-tax jurisdiction in an effort to reduce the tax cost of the group. Whatever the purpose may be, the point is that these transfers between companies within the same group may not be seen as a genuine “sale” transaction as the IP would still be owned within the group of companies.

Another method of acquiring IP is to have it developed internally. Businesses developing IP would generally have dedicated staff and assets for the research and development of the IP. This can prove quite costly for businesses, both in terms of time and money. Furthermore, the success of developing one’s own IP cannot always be determined at the start, which could result in unnecessary losses for the company.

In light of these difficulties, companies could opt to “lease” IP. In most cases, this could be a much more affordable option for businesses. Furthermore, this would negate the need to look for a willing seller of an IP, as the ownership of the IP would still remain with the lessor when the IP is leased. The consideration paid to the owner of the IP for its lease is commonly referred to as a royalty.

### 1.1.3. **Payment for the use of IP**

As mentioned above, the consideration paid to the owner of IP, which is being leased, is commonly referred to as a royalty. However, unlike tangible assets, IP has no physical substance and therefore cannot be physically transferred to the lessee. When a tangible asset is leased, it is transferred to the lessee for a stipulated period of time. When an IP is leased, there is no physical transfer to the lessee. So, for example, if a clothing manufacturer wants to print a popular brand on its t-shirts, and the owner has registered the brand as copyright or trademark, the clothing manufacturer would have to pay a “royalty” to the owner of the brand for using the brand (i.e. trademark) on its t-shirts. Accordingly, there is no asset transferred to the clothing manufacturer. Therefore, it would be correct to say that a “royalty” is paid as the consideration for the use of IP.
1.1.4. **South African tax consequences for the use of IP**

The Income Tax Act, 58 of 1962 (“the ITA”) specifically provides for the tax consequences on the receipt of the use of IPs (i.e. royalties). Paragraph (g)(iii) of the “gross income” definition, contained in section 1 of the ITA, specifically includes receipts for the use of certain IP. Accordingly, the receipt of a royalty payment would be included in gross income.

South Africa (“SA”) has a residence and source basis of taxation. This means that non-residents are subject to SA tax on income that has its source or deemed source within SA. Accordingly, royalties earned by non-residents from a source or deemed source in SA, are subject to SA tax.

The ITA has made specific provisions for the taxation of non-resident recipients of royalties paid by a SA tax resident. As mentioned in 1.3 below, determining whether a royalty has its source or deemed source within SA is beyond the scope of this dissertation. However, for the purposes of this dissertation, the legal principles are briefly explained below.

The “deemed source” provisions are contained in Section 9 of the ITA and these provisions essentially deem an amount to be from a source in SA, regardless of where the “true” source is situated.

Specifically, section 9(1) deems the source of amounts received to be from a SA source if it is received for the following:

(b) the use or right of use in the Republic of, or the grant of permission to use in the Republic—

(i) any patent (…..); or

(ii) motion picture (…..), contemplated in section 35;

bA) the imparting of or undertaking to impart (…..) for use in the Republic (…..), as contemplated in section 35;\(^2\)

\(^2\) The exact wording of these sections will be considered in later chapters.
Accordingly, if these provisions are met, the royalty will be included in the non-residents gross income.

However, section 10(1)(l) exempts from taxable income “any amount received by or accrued to any person which amount has been subject to withholding tax in terms of the provisions of section 35”. Therefore, section 35 is the effective taxing provision for royalties, received by a non-resident, where the source or deemed source is in SA.

Section 35 of the ITA states the following:

“(1) Any person (other than a resident or a controlled foreign company) by whom any amount is received or to whom any amount accrues by virtue of—

(a) the use or right of use in the Republic of, or the grant of permission to use in the Republic—

(i) any patent (…); or

(ii) any motion picture film, (…).

[……………….]; or

(b) the imparting of or the undertaking to impart, [………………..],

shall be liable for tax, to be known as the withholding tax on royalties, which shall be levied and paid for the benefit of the National Revenue Fund at a rate of 12 per cent of such amount.”

Section 35 of the ITA effectively taxes the non-resident at 12% in respect of royalty receipts from a SA source.

The tax to be withheld must be subtracted from the royalty payment to the non-resident. Notwithstanding that the SA resident is responsible for withholding the tax and paying it over to the South African Revenue Service (“SARS”), the non-resident ultimately bears the tax cost.

The non-resident could also be subject to tax on the royalty received in the country of tax residence (“residence state”). This is likely to arise where the residence state applies a residence basis of taxation. To avoid paying double-tax, tax relief could be sought either
in terms of the residence state’s domestic legislation or a Double Tax Agreement (“DTA”) with SA, should one be in place.

1.2. **RESEARCH PROBLEM**

1.2.1. **Official definition of “royalty”**

Although mentioned above that the receipt of royalties is included in gross income, the term ‘royalty’ is not defined in the ITA. However, this word is used throughout the ITA without a corresponding definition. It is not certain as to what meaning should be given to this word as the meaning varies (e.g. the dictionary meaning differs from the common law meaning).

The difficulties arising from the lack of definition and the basis for a potential definition is discussed in Chapter 2.

1.2.2. **Know-how versus services rendered**

As previously mentioned, section 35 of the ITA subjects any royalty payment made to a non-resident to a withholding tax of 12% unless the non-resident seeks relief from, *inter alia*, a DTA with South Africa, should one exist.

Article 12 of the Organisation of Economic Co-operation and Development’s (“OECD”) Model DTA provides exclusive taxing rights to the Contracting State of which the beneficial owner of the royalty is resident. So, in instances where the DTA between South Africa and the non-resident’s country mirrors the OECD’s Model DTA (“OECD DTA”), the withholding tax may not be levied on the royalty as only the residence state has the taxing right. Accordingly, SA would be denied the withholding tax on royalty payments to the non-resident if that non-resident is the beneficial owner of those royalty payments and if a DTA modelled on the OECD DTA is in place.

Problems can arise as the wording of section 35 of the ITA and the OECD DTA do not entirely agree. Both section 35 and the DTA include payments for the use of intellectual property and for imparting knowledge or information in relation to that intellectual property. However, section 35 also includes services rendered in connection with the
application or utilisation of such knowledge or information, whereas the OECD DTA does not.

This could result in double taxation if these “services rendered” are not covered elsewhere in the DTA e.g. Article 7 (Business Profits) to the extent that the payment of the services rendered are derived from an asset connected to a business establishment; and, Article 15 (Income from employment) to the extent that the requirements in that article are met.

The above issues are addressed in Chapter 3.

1.2.3. **Property or rights of a similar nature**

Section 35 of the ITA includes payments for the use or the right to use “property or rights of a similar nature”, whereas the OECD DTA does not. Accordingly, payments for the use of such property will not be subject to relief in Article 12.

The term “property or rights of a similar nature” is not defined in the ITA and therefore it is not certain what items are included therein. Chapter 4 analyses the term in the context of section 35 and provides guidance on determining whether specific IP would be classified as “property or right of a similar nature”.

1.3. **LIMITATION OF SCOPE**

The scope of this dissertation is limited to the identification of a royalty (i.e. whether an amount is in fact a royalty for the purposes of section 35 of the ITA and/or Article 12 of the OECD DTA). Key to the dissertation is the identification of those characteristics that, together, are considered to define a royalty.

Article 12 of the OECD DTA is applicable to non-residents who are the beneficial owner of the royalties. This dissertation will not deal with the issue as to whether the non-resident in question is the beneficial owner of the royalty. For the purposes of this dissertation, it will be assumed that the non-resident is the beneficial owner of the royalty receipt and accordingly, entitled to enjoy tax relief in terms of Article 12, where the royalty is of the type contemplated in the DTA.
Other tax related issues regarding royalties include, *inter alia*, the source of the royalty and whether the royalty establishes a permanent establishment in the other country. These issues will not be considered in this dissertation. Section 35 of the ITA only applies to royalties where the source or deemed source is in SA. Article 12 of the OECD DTA excludes any royalties that arises through a permanent establishment and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment.

For the purposes of this dissertation, it will be assumed that in all instances, the royalties will have their source or deemed source in SA. Furthermore, it will be assumed that the royalty does not arise through a permanent establishment.

Finally, this dissertation is based on the ITA as amended up to the amendments contained in the Voluntary Disclosure Programme and Taxation Laws Second Amendment Act, No. 8 of 2010. Amendments have been proposed to sections 9 and 35 of the ITA in draft amendment bills\(^3\) (which was subsequently enacted by the Taxation Laws Amendment Act 24 of 2011) issued during the 2011 calendar year. However, Chapter 2 will include a brief explanation as to why these proposed amendments will not change the relevance of this dissertation.

1.4. **DIRECTION OF DISSERTATION**

The first part of this dissertation considers the meaning of a royalty as used in the ITA and the necessity of implementing an official definition.

Thereafter, the dissertation will focus on section 35. Specifically, two aspects of section 35 will be considered, namely, distinguishing know-how from services rendered and the scope of the phrase “property or rights of a similar nature”.

1.4.1. **Know-how, show-how and services rendered**

Both the ITA and the OECD DTA refer to payments for the use of certain IP and for the imparting of certain knowledge (i.e. know-how). However, only the ITA also refers to services rendered. The question arises as to whether these services rendered should be considered as part of imparting know-how (in which case it would be covered by Article

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\(^3\) Taxation Laws Amendment Bill 19 of 2011 and the Taxation Laws Second Amendment Bill 20 of 2011
12 of the OECD DTA) or whether they should be considered purely as services rendered and accordingly, excluded from the scope of Article 12.

To address this issue, the dissertation will consider relevant definitions in both the ITA and the OECD DTA. The dissertation will also consider the dictionary definitions of those terms. Relevant case law considering know-how payments will also be reviewed to determine whether or not any guidance can be drawn from these cases.

The purpose of taking this approach is to determine if there is any guidance which could assist in identifying firstly, the type of services that are envisaged in section 35 and secondly, whether such services are part of imparting know-how (which falls within the scope of Article 12).

1.4.2. Property or rights of a similar nature

There is no specific definition for the term “property or right of a similar nature” as stated in section 35. The dissertation will address what is meant by this term and specifically, how to determine whether a specific item is a “property or right of a similar nature”.

1.5. METHODOLOGY

1.5.1. Rules and legal principles of interpretation

This research will seek to define a term used in both the ITA and the OECD DTA.

Accordingly, the principles of interpretation of fiscal legislation in South Africa will be used in this dissertation with the focus on the principle of literal interpretation and departure therefrom. In this regard, consideration is also given to the common law principles as are applicable to SA.

In interpreting legislation, including fiscal legislation, courts in South Africa use common law rules of interpretation in the absence of codified definitions. The principle of interpretation used by South African courts stems from the English case *Partington v The Attorney-General.*4 This principle has been used in the South African

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4 21 LT 370
court case *Commissioner for Inland Revenue v George Forest Timber Company Limited*\(^5\)

where at page 29, De Villiers JA quoted the following from the *Partington* case:

“……. If a person sought to be taxed comes within the letter of the law, he must be taxed, however great the hardship may appear to the judicial mind to be. On the other hand, if the Crown, seeking to recover the tax, cannot bring the subject within the letter of the law, the subject is free, however apparently within the law the case might otherwise appear to be. In other words, if there be an equitable construction, certainly such a construction is not admissible in a taxing statute, where you can simply adhere to the words of the statute.”

It follows that the literal interpretation of the wording of the ITA must be followed. Courts will only depart from the literal interpretation if the meaning if the wording is ambiguous or does not reflect the true intention of parliament. In *Savage v Commissioner for Inland Revenue*\(^6\) Centlivres CJ, referring to a previous case, quoted the following at page 9:

“……That rule is that, where the language of a statute is unambiguous, and its meaning is clear, the court may only depart from such meaning “if it leads to absurdity so glaring that it could never have been contemplated by the Legislature, or if it leads to a result contrary to the intention of Parliament as shown by the context or by such other considerations as the Court is justified in taking into account”

The principle follows that if the wording does not reflect the intention of the Legislature, then the courts may depart from the literal interpretation of the wording to apply such intention. However, the intention of the Legislature must be clear.

There are instances where the wording of legislation is ambiguous and the intention of legislation is not clear. In this regard the *contra fiscum* rule of interpretation should be followed.

The *contra fiscum* rule applies where there is doubt as to the intention of the Legislature. This rule works in favour of the taxpayer (i.e. against the fiscus). However, this rule may only be used if the intention of the Legislature is not clear.

Steyn (2009)\(^7\) indicates that courts have begun to use the so called “purposive approach” as an interpretation method. In this regard, he refers to *Commissioner for the South

\(^5\) (1940) 1 SATC 20
\(^6\) (1951) 18 SATC 1
\(^7\) Steyn, M.T. 2009. *Interpretation of Fiscal Legislation*. Cape Town, University of Cape Town [Seminar Notes]
African Revenue Service v Airworld CC and Another⁸ where Hurt AJA stated the following at paragraph 25:

“The interpreter must endeavour to arrive at an interpretation which gives effect to such purpose. The purpose … is used, in conjunction with the appropriate meaning of the language of the provision, as a guide in order to ascertain the Legislature’s intention.”

It follows that the purpose of a relevant provision should be ascertained and this purpose is then used to assist in determining the intention of legislature in respect of the specific provision.

To conclude, it is the intention of the legislature that is the over-riding factor when interpreting fiscal legislation. The intention should be clearly illustrated in the wording of the legislation. Accordingly, the literal interpretation of the ITA should be followed. If the wording does not reflect the intention of the legislature, and that intention is abundantly clear, then the intention should be followed. In this regard, the purpose of the relevant provision should be ascertained and this will assist in determining the intention of the legislature in respect of that provision. If neither the wording of the legislation nor the intention of the legislature is clear, then the contra fiscum rule will apply and accordingly, the benefit of the doubt would go to the taxpayer.

1.5.2. Interpretation principles of DTAs

South Africa is not a member state of the OECD and is therefore not required to follow the OECD DTA model. However, South Africa does have observer status. Most of the DTAs in place between South Africa and other states follow the OECD DTA model. For this reason, the OECD DTA model will be used as a proxy for South African DTAs for the purposes of this dissertation.

Although the OECD DTA contains a definition for “royalty”, it is still necessary to interpret parts of the definition (e.g. the meaning of “use”). With regards to the interpretation of DTAs, the decision in the case SIR v Downing⁹ is a commonly used reference. In this case, the court had to decide on whether a Swiss company had a permanent establishment in SA. The court had to, inter alia, determine the meaning of the wording in Article 5 (definition of Permanent Establishment) of the treaty. In this regard,

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⁸ (2007) 70 SATC 48
⁹ 1957 (37 SATC 249)
the court referred to the wording of the Article to interpret its meaning. At 258, Corbett, JA states the following:

“Article 5(5) is curiously worded in that it is cast in an essentially negative mould. Thus the phrase used is ‘ . . . shall not be deemed to have . . . ’, instead of ‘ . . . shall be deemed not to have . . . ’ This form of wording seems to be due to the fact that this paragraph is intended to cover only the case of a person who ‘merely’ carries on business, ie does no more than carry on business, through an agent of independent status, who himself acts in the ordinary course of his business. Despite its negative form, para 5 must, in my view, be interpreted as meaning that where, for example, a Swiss resident does no more than carry on business through a South African broker and the latter, in transacting that business on behalf of his Swiss principal, acts in the ordinary course of his business, the Swiss resident must be deemed not to have a permanent establishment in South Africa.”

The above illustrates that the court has used the literal interpretation of the DTA (as opposed to its intention) in interpreting the Article.

The commentaries of the relevant Articles will also be considered. However, these commentaries are not legally binding and therefore cannot be relied upon. The condensed version\(^{10}\) of the OECD DTA contains the following comment on page 14:

“For each Article in the Convention, there is a detailed Commentary that is intended to illustrate or interpret its provisions. As the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of member countries, they are of special importance in the development of international fiscal law. Although the Commentaries are not designed to be annexed in any manner to the conventions signed by member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes.”

It follows that the commentaries, although not legally binding, are a useful interpretation tool for member countries. However, as SA is not a member state, there is debate as to what role the commentaries will play in SA’s domestic legislature. A consideration of what role the commentaries will play in SA is beyond the scope of this dissertation and will not be considered further. For the purposes of this dissertation, it is assumed that the commentaries will be persuasive in the interpretation of SA’s DTAs.

\(^{10}\) OECD. 2010. *Model Tax Convention on Income and on Capital*
1.5.3. **Research Methodology**

A “doctrinal research” approach would be adopted for the majority of the dissertation, which involves identifying analysing and concluding on current legislation. However, as this dissertation attempts to show that a change in the law may be required, certain aspects would be of a “non-doctrinal research” approach (i.e. researching something that is currently not in the current legislation).\(^{11}\)

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CHAPTER 2: DEFINING A ROYALTY FOR SA PURPOSES

2.1. INTRODUCTION

The purpose of this chapter is to ascertain, for SA purposes, the meaning of a royalty, using, *inter alia*, the wording contained in the ITA, the OECD DTA definition as well as the Common Law for guidance.

2.2. DEFINING A ROYALTY FOR THE PURPOSES OF THE ITA

It should be noted from the outset, that there is no definition of a royalty in the ITA, despite the word being used at various points in the ITA. However, the ITA appears to use similar wording for what would commonly be referred to as a royalty (without expressly stating that it is a royalty). This is discussed in more detail below.

2.2.1. Some sections of the ITA containing the word “royalty”

The first section containing the word royalty is section 7, specifically, sub-paragraph 7. Section 7 deems the income earned by one person to be that of another person. In other words, section 7(7) states that if any person’s right to receive a royalty has been ceded to another person by reason of any donation, settlement or other disposition made, that royalty will be deemed, in terms of that section, to be that of the first person (provided that certain requirements are met).

Section 9D of the ITA (i.e. the CFC provisions) uses the word “royalties” at various points throughout that section. Section 9D(2A)(c) disallows a deduction for royalties from imputable CFC income paid to another CFC within the same group. Section 9D(9)(b)(iii) excludes royalties from the foreign business establishment (“FBE”) exemption (income that is attributable to a FBE is exempt from imputation – royalties are specifically excluded). Section 9D(b)(iii)(dd) then includes in the FBE exemption, those royalties which have arisen from IP as defined in section 23I of the ITA.

Section 12E of the ITA, which consists of the provisions relating to deductions available for small business corporations (as defined) also mentions the word royalties, which is included in the definition of “investment income”.
Although the above sections mention the word royalties, the term is not defined in any of these sections. Therefore, the question is what is meaning of the term royalty in the context of these sections (and for SA tax purposes generally)?

2.2.2. **Sections of the ITA describing a royalty**

It would appear that the Legislature has been reluctant in providing definition for a royalty in the ITA, despite using the term extensively in various provisions, specifically in section 35, the definition of gross income and in section 9(1).

2.2.2.1. **Section 35**

Section 35 of the ITA is the only section that provides an indication of what a royalty could be understood to include (as explained below). This description is contained in section 35(1) and reads as follows (the relevant extracts):

“(1) Any person (other than a resident or a controlled foreign company) by whom any amount is received or to whom any amount accrues by virtue of—

(a) the use or right of use in the Republic of, or the grant of permission to use in the Republic

(i) any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No. 195 of 1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978), or any model, pattern, plan, formula or process or any other property or right of a similar nature; or

(ii) any motion picture film, or any film or video tape or disc for use in connection with television, or any sound recording or advertising matter used or intended to be used in connection with such motion picture film, film or video tape or disc,

(.............); or

(b) the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information for use in the Republic, 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. (.............),
shall be liable for tax, to be known as the withholding tax on royalties, which shall be levied and paid for the benefit of the National Revenue Fund at a rate of 12 per cent of such amount.” (underlined - writers own emphasis)

Essentially, this section describes what would be subject to a withholding tax on royalties, as opposed to describing what would constitute a royalty. As mentioned previously, there is no royalty definition in the ITA. However, the description as contained in section 35(1) of the ITA does provide the strongest guidance as to what would constitute a royalty. It is important to note that section 35 (as its heading indicates) applies to “royalties and similar payments”. Therefore, the scope of section 35 is not limited to royalties alone.

2.2.2.2. Gross income definition

The gross income definition contains wording essentially similar to the wording contained in section 35 to describe amounts loosely referred to as a royalty.

Paragraph (g)(ii)bis of the gross income definition, brings into income amounts received or accrued:

“for the use or the right of use of any motion picture film or any film or video tape or disc for use in connection with television or any sound recording or advertising matter connected with such motion picture film, film or video tape or disc”.

Paragraph (g)(iii) of the gross income definition, brings into income amounts received or accrued:

“for the use or right of use of any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No. 195 of 1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978), or any model, pattern, plan, formula or process or any other property or right of a similar nature”.

Paragraph (g)(A) of the gross income definition, brings into income amounts received or accrued:

“any amount received or accrued from another person as consideration (or payment of like nature) for the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or for the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information”.

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2.2.2.3. **Deemed source provisions**

Section 9(1) of the ITA deems the source of certain income to be in SA. The deeming provisions for amounts in the nature of royalties are contained in sections 9(1)(b) and (bA). The wording of these sections is essentially the same as the wording of section 35. Furthermore, both subsections 9(1)(b) and (bA) ends with the term “as contemplated in section 35”.

Although it is commonly accepted that these provisions are referring to a royalty, this is not expressly stated.

2.2.2.4. **Conclusion**

From the above, it can be seen that the wording of what is to be taxed in accordance with section 35 is almost identical with the above quoted paragraphs from the “Gross Income” definition and sections 9(1)(b) and (bA) (i.e. the deemed source provisions). This is unsurprising as the sections are linked. It could be that the intention was to ascribe a different / more specific meaning to the term royalty where used at various points in the ITA. However, this would involve ascertaining the intention of each of those sections and such a study would fall outside the scope of this dissertation as the overall goal of this dissertation would be to determine a definition that could be used throughout the ITA.

These sections therefore provide the greatest guidance from the ITA as to the amounts to be considered as “royalties” for the purposes of the ITA. However, it is submitted that the definition of “royalty” should not be “hidden” within the provisions of the ITA.

2.2.3. **“Definition structure” of royalties for the purposes of the ITA**

Based on the wording of the ITA, a structure of the meaning of royalties can be deduced. If looked at simplistically, the structure is as follows:

(1) amounts received for the use of IP; and

(2) amounts received for the impartation of knowledge, as well as for services rendered in connection with that knowledge.
2.2.4. **Use of wording in the ITA as “official” definition**

As the ITA uses the same wording at various points, the next step is to consider whether this wording should be used to define the term “royalty” when used in other sections of the ITA. Specifically, as section 35 provides the strongest guidance on the meaning of a royalty, it should be considered whether or not it was the intention of Legislature to refer to the wording of section 35 to define a royalty and whether or not it is necessary to insert a definition into the ITA using the wording of section 35.

2.3. **OECD DTA DEFINITION OF ROYALTY**

Before investigating the intention of the legislature with regards to the insertion of the word royalty at various points in the ITA (without a corresponding definition), it would be useful to analyse existing definitions from other sources. A starting point would be to consider the OECD DTA definition.

2.3.1. **Article 12**

Royalties are in the subject of Article 12 of the OECD DTA. As stated in Chapter 1, Article 12 provides exclusive taxing rights to the Contracting State of which the beneficial owner of the royalty is resident. Furthermore, unlike the ITA, Article 12 of the OECD DTA provides a definition for a royalty. This definition is contained in 12(2) and reads as follows:

“The term “royalties” as used in the Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematography films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.”

Broken down, the OECD DTA definition refers to the following two components:

- Payments for the use of:
  - any copyright of literary, artistic or scientific work including cinematography films
  - patent
  - trademark
  - design
Payments for the use of:

- model, plan, secret formula or process
- information concerning industrial, commercial or scientific experience

It can be seen that the OECD DTA definition is very similar to the wording contained in section 35 of the ITA as they both consist of two components (see 2.2.3.) and the IPs specifically identified are mainly the same. However, there are a few differences between the OECD DTA definition and the wording of the ITA.

The first difference identified is that the OECD DTA definition does not refer to amounts for the use of any other property or right of a similar nature. The second difference is that the OECD DTA definition excludes amounts for the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of any knowledge or information. These differences are specifically dealt with in later chapters of this dissertation.

There are other more subtle differences, e.g. the OECD DTA does not include information for “technical knowledge” which is included in the wording of section 35 of the ITA along with “industrial, commercial or scientific experience” as used by the OECD definition. It is therefore evident that a different meaning must have been intended for “technical knowledge” However, such subtleties will not be considered in this dissertation.

2.3.2. **OECD DTA Commentary**

Commentary on the OECD DTA definition of royalties provides useful insight into the internationally accepted characteristics of royalties. The OECD DTA commentary is drafted and agreed upon by experts with the intention to, *inter alia*, interpret the provisions of the OECD DTA and are referred to by tax administrators and taxpayers of member states.\(^\text{12}\) Accordingly, their importance should not be underestimated.

Some of the more important commentaries are considered below.

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\(^\text{12}\) OECD DTA, 2010 at page 14.
2.3.2.1. Ownership

In terms of the commentary on the definition of royalties, payments made to persons that do not own the IP or the right to use it are likely not to be royalties for the purposes of Article 12.\(^\text{13}\)

Therefore, as an initial step in determining whether an amount (paid or received) is a royalty, one would need to determine whether the recipient of such a payment is the owner of the IP or has a licence or right of some other sort to use that IP.

Although included in the commentary of the OECD DTA, and therefore likely to be followed for treaty application purposes, this is not expressly stated in the definition.

In “Beneficial Ownership of Royalties in Bilateral Tax Treaties”,\(^\text{14}\) Du Toit states the following after analysing a foreign court case relating to royalties:

“...the bilateral treaty defined royalties as payments for the use of, or the right to use copyright. That means that the person receiving the payments must have the right to grant the copyright, either because he is the copyright owner or has a licence to use the copyright”.\(^\text{15}\)

Therefore, the use of the wording “payment for the use of, or the right to use” in the OECD definition appears to have the effect that the payment must be made to the owner (or licensor) of that right.

As section 35 contains the same wording, it is submitted that the current wording in that section would not need to be amended in respect of the “ownership” requirement, should section 35 be used as a basis for a definition.

2.3.2.2. Sale versus Use

It is generally accepted that the receipt of an outright transfer of IP would not constitute a royalty as it is not an amount for the “use or the right to use” that IP. Support can be found in the BP\(^\text{16}\) case where the court needed to decide whether an annual payment made for the use of licenced marks was of a capital or revenue nature. At 13, while referring to

\(^{13}\) OECD DTA, 2010 at page 222, paragraph 8.1.


\(^{15}\) Du Toit, supra. Note 14, page 39

\(^{16}\) BPSA (Pty) Ltd v The Commissioner for SARS [2007] SCA 7
the annual royalty payment, Ponnan JA stated that “It’s purpose was to procure for BPSA the use – not ownership – of the intellectual property of another from its sole and rightful owner...Thus the ownership of the intellectual property remained with BP”. This supported the judgment that the payment was revenue in nature. Although the judgment is not relevant for the purposes of this dissertation, it can be deduced from the above quote that, had the purpose of the payment been for the ownership of the intellectual property, it would not be revenue in nature, and therefore unlikely to be referred to as a “royalty”.

Further support can be found in the commentary.\(^\text{17}\) However, the commentary also points out the difficulty that could arise when rights are transferred and those rights form part of the IP which results in an alienation of those rights for the grantor / transferor. This would, for example, be the case where exclusive rights are granted where the grantee has the sole right to use that IP for a specified period of time or within a specified geographic location (i.e. the grantor may not exercise the rights).

Amounts received in this regard would not necessarily constitute a royalty. However, the commentary rightly states that each case will depend on its particular facts as well as local legislation pertaining to IP.

This is different to payments made to the owner or holder of those rights to prevent that owner or holder from granting anyone else the use of those rights. In such a case, the amount would fall within the scope of the definition of royalties.\(^\text{18}\)

In conclusion, the point to remember is that the distinction of granting the right to use versus an outright transfer is necessary to determine whether an amount would constitute a royalty.

2.3.2.3. Distribution

Amounts received for the granting of a right to distribute a product or service (i.e. distribution rights) would not constitute royalties as they are not made in consideration for the use or the right to use an IP.\(^\text{19}\) These amounts are more likely to fall under Article 7 “Business Profits”.

\(^{17}\) OECD DTA, 2010 at page 222, paragraph 8.2.
\(^{18}\) OECD DTA, 2010 at page 222, paragraph 8.5.
\(^{19}\) OECD DTA, 2010 at page 222, paragraph 10.1.
Therefore, if a company obtains a right to distribute branded clothing in its country of residence, the payments would not be for the right to use the brand but rather for the right to sell the branded products. However, if the company manufactures and distributes the branded clothing, the payment would more likely be a royalty as the company could argue that the payment was in respect of the use of the brand on the clothing.

It is submitted that this commentary emphasises that the amount in question must be for the use or the right to use IP in order for that amount to be classified as a royalty. This is supported by SA case law considered below.

2.3.3. OECD DTA definition as a basis for a SA definition

The definition of a royalty in the OECD DTA is very similar to section 35 of the ITA. In addition, the main points in the commentary do not appear to differentiate the OECD DTA definition from the wording in section 35. In fact, it appears to support the wording. Accordingly, it is submitted that the OECD DTA definition would support any proposal to use the wording in section 35 as the definition or could be used as the basis for building a definition.

2.4. COMMON LAW DEFINITION

South Africa has a mixed legal system, incorporating both civil law (statute law) and common law. Accordingly, if a term is not defined in a statute (as is in this instance), courts would need to look at that term’s common law meaning.

2.4.1. SA case law

Common law in SA has evolved overtime, mainly through court judgements. SA court cases involving the definition (or lack thereof) of a royalty is very limited.

2.4.1.1. ITC 1087

In ITC 1087\(^{20}\) the court had to decide whether payments received by a company resident in Sweden, from a company resident in the former Federation of Rhodesia and Nyasaland, would constitute rentals or royalties for the purpose of the DTA between the two states.

\(^{20}\) ITC 1087 (1966) 28 SATC 196(R)
In this case, the Swedish company entered into an agreement whereby it would, *inter alia*, hire certain machinery for a period of three years to the Rhodesian company. As compensation, the Rhodesian company would have to pay a “production rental” which is based on the quantity of products manufactured by the machinery. The issue was whether or not the “production rentals” would constitute royalties in terms of Article IX of the DTA between the two states (which would then be exempt from tax). The argument was that the products manufactured by the machines were the subject of a number of patents held by the Swedish company and that the Rhodesian company was granted a licence to manufacture the products in accordance with the patents. At 201, J.M. Greenfield said the following:

“I do not consider that … ‘production rentals’, constitutes royalties as defined in Article IX 2 …. Article IX 2 exempts royalties for the use of patents, trade marks, etc. In the present case the rental, or royalty (if that is a better description) was for the use of the machines, not the use of the trade mark or patents as such.”

It is submitted that, in order for an amount to be classified as a royalty for the purposes of the ITA, it would appear that the payment should specifically be in respect for the use of IP. In *ITC 1087*, the payment was not for the use of a patent and accordingly, not a royalty. The mere fact that the products manufactured by the machines were subject to a number of patents (and therefore, the taxpayer may have indirectly used those patents) does not change the nature of the payment. The payment was for the use of machinery and therefore not royalties as defined in Article IX 2. This supports the OECD DTA commentary on the definition of royalties where it was noted that the payments need to be in respect of the use of IP in order for it to be classified as a royalty.

2.4.1.2. *ITC 1735*

In *ITC 1735* the court had to decide whether a payment made to a professional golfer during a tournament in SA was, *inter alia*, a royalty payment (which would therefore be subject to a lower rate of tax in SA). In terms of an agreement with the tournament host, the golfer would allow the host to use his likeness, biographical material, his presence at promotional events and media conferences and repeat television/video utilisation of his participation in the Tournament. The written agreement specifically describes the payment as a “royalty”.

21 *ITC 1735* (2002) 64 SATC 455
One of the arguments submitted by the Appellant (the Golfer) was that the payment constituted a royalty payment as defined in the DTA between SA and the UK. Specifically, the Appellant implied that his name, likeness and biographical materially were property in respect of which he owned the copyright (payments for the use or right to use any copyright was included in the definition of royalties as per the then version of the DTA between SA and the UK). To this submission, the court made the following comments at 462:

“The payment was not a royalty as defined as the monies were not paid for the right to use any of the property referred to in art 11(2)(a) of the DTA. As we understood appellant’s argument it was contended that the appellant’s name, likeness and biographical material were property in respect of which he owned the copyright. This argument entirely overlooks what is meant by the word ‘copyright’. The following exposition by JC Copeling and AJ Smith in ‘The Law of South Africa’ (Vol 5 Part 2 of First Reissue’) clearly sets out the legal position:

‘Copyright law is created only by statute and is governed by the provisions of the Copyright Act as amended. This Act states that no copyright or right in the nature of copyright may subsist otherwise than by virtue of the Act or some other enactment in that behalf… for copyright to subsist in a work, the work must be original in character. In essence, this means that the work must be created as a result of the skill and effort of the creator and not be copied from another source…”

The Appellant placed no evidence before us that any of the items over which he alleged he owned the copyright were the result of his skill and effort.”

In essence, the court referred to the legal meaning of the word “copyright”, as well as to comments from legal commentators, in determining whether the Appellant’s name, likeness etc. were property in respect of which the Appellant owned the copyright (and therefore the payment in question would be for the use of Appellant’s copyright). The court concluded that this was not the case and accordingly, the payment received by the Appellant would not be for the use of his copyright (and accordingly, not a royalty as defined in the SA/UK DTA).

It should be noted that, subsequent to this judgement, section 35 was amended to specifically clarify that the patents, designs, trademarks and copyrights to which the section refers are those as defined in their respective acts.
However, section 35 still refers to amounts for the use of any model, pattern, plan, formula or process (which are not defined in the ITA, nor are they referenced to any other act). These terms will be considered later when considering the term “property or rights of a similar nature”.

In summary, it would appear that SA courts are fairly strict in considering whether an amount would be a royalty for purposes of section 35 (and possibly for the purposes of the entire ITA as well), as, based on the judgement of this case, the amount should be strictly for the use for one of the items listed in section 35.

2.4.2. Foreign case law

Foreign court judgements, although not binding on South African courts, do have persuasive value. Due to the lack of local court decisions on this specific topic, it would be highly likely that our courts will consider foreign court cases should they be confronted with a case involving defining a royalty. Accordingly, a consideration of foreign court cases would be useful.

In “Beneficial ownership of Royalties in Bilateral Tax Treaties”,22 a detailed consideration was given to the common law meaning of royalties and reference was made to various international cases dealing with the meaning of a royalty. This dissertation will briefly deal with some of those cases to draw out the more important points that will assist in defining a royalty.

In an Australian court case, McCauley v Federal Commissioner of Taxation,23 the taxpayer entered into an agreement whereby he would sell to the purchaser the right to cut and remove the standing milling timber growing on a specified area of land owned by the taxpayer. The consideration would be a price or royalty based on the quantity of timber cut. Essentially, the court had to decide whether this consideration was a royalty. In dismissing the taxpayers appeal, Latham C.J. said the following at 241:

“In my opinion the word "royalty" is properly used for the purpose of describing payments made by a person for the right to enter upon land for the purpose of cutting timber of which he becomes the owner, where those payments are made in relation to the quantity of timber cut or removed. Thus I

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22 Du Toit. supra. Note 14
23 (1944) 69 CLR 235
am of opinion that the moneys received by McCauley were royalties and accordingly were part of his assessable income.”

Stanton v Federal Commissioner of Taxation\textsuperscript{24} is another Australian case involving timber. In this case, the taxpayer entered into an agreement with another party whereby the taxpayer sold a certain quantity of millable timber with the right to cut and remove the timber from the land. The payment would be made in equal instalments without interest.

The court placed great emphasis on the fact that the payment was not calculated by reference to the actual timber that has been cut or removed.\textsuperscript{25} In this regard, the court distinguished this case from the McCauley case (where the consideration was based on the quantity of timber cut). At 642, the court stated the following:

“The transaction enabled the saw-miller and indeed bound him to take stands of timber for defined prices which were payable whether he exercised the right or not and the price was not calculated upon the amount taken but only upon the amount of timber of the described kind and girth found to be standing upon the land. It follows that the payments were not royalties and ought not to have been included in the assessable income. The question in the case stated should be answered: No.”

Based on these cases, it would appear that amounts based on the quantity of use are more likely to be considered a royalty from a common law perspective. However, this is not definitive as was shown in Pierre Boulez v. Commissioner for Internal Revenue.\textsuperscript{26}

In the Pierre Boulez case, the court had to decide whether payments made to an orchestra conductor for providing private recordings for the purpose of making records were payments for royalties or for personal services. The calculation of the payments was based on, \textit{inter alia}, the future sales of the recordings. The court found that these payments amounted to payments for personal services rendered as the conductor did not have any interest in the recordings. At 593, Judge Korner said the following:

“Before a person can derive income from royalties, it is fundamental that he must have an ownership interest in the property whose licensing or sale gives rise to the income”.

\textsuperscript{24} (1955) 92CLR 630
\textsuperscript{25} At 638, the court said the following: “Upon the question whether the payments fill the character of a royalty there are some other provisions in the agreement that have some importance. They make it quite clear that the moneys are not calculated by reference to nor payable in respect of the timber actually cut or removed and that cutting or removal is not the occasion of the payments.”
\textsuperscript{26} 83 T.C. 584 (1984)
Du Toit agrees with this judgment and concludes that a person must either be the copyright owner or have a licence to use the copyright before that person may grant another person to use that copyright in return for a royalty.  

2.4.3. **Features of a common law royalty**

Du Toit includes the following summary of the features for a common law royalty obtained from Woellner:

1. “(1) it is a payment made in return for the right to exercise a “beneficial privilege” or right (e.g. to remove minerals, utilize a process, or produce a play);

2. (2) the payment is made to the person holding the ownership or other rights which enable him to confer that beneficial privilege;

3. (3) the consideration payable is linked to the amount of use made of the right acquired (e.g. a payment of x cents per performance, per cubic yard taken or per item manufactured/sold);

4. (4) the consideration will usually be paid as and when the privilege acquired is exercised. This is not necessarily so, however, and a lump sum may constitute a royalty where it is a pre-estimate or ex post facto recognition of user;

5. (5) an amount unrelated to any estimate of likely amount of use, and which is simply an amount paid to acquire the right to exercise a privilege (regardless of whether or not that right is actually used) will not normally be a common law royalty, even if paid in instalments.”

It would appear that points 1 and 2 have found their way into section 35 whereas points 3, 4 and 5 have not.

Points 3, 4 and 5 appear to link the royalty to the quantity used / amount of products produced as a result of using the right. Although this aspect is mentioned numerous times in the above summary, it is important to note that these are all merely indicators of what could constitute a royalty (whether looked at in conjunction with each other or in isolation) and each case would need to be considered separately (i.e. in determining whether an amount would constitute a royalty).

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2.4.4. **Common law definition versus section 35 wording**

As the focus is on whether the wording of section 35 is suitable as a basis for a definition of a royalty, it is necessary to compare this wording to the common law meaning.

The first difference between the common law definition and the wording contained in section 35 is that the common law definition of a royalty does not include amounts for the impartation of knowledge and for services rendered in respect of the application or utilisation of that knowledge (i.e. the second part of the definition structure explained in 2.2.3). This has been separately included in both section 35 and the OECD DTA definition.

While section 35 of the ITA excludes royalties for the extraction of minerals (as opposed to point 1 of Woellner’s summary), this is governed by a separate Act in SA (which is beyond the scope of this dissertation) and therefore it would seem appropriate to exclude this from the scope of section 35.

If a comparison is made to Woellner’s summary above, it is submitted that points (1) and (2) would be partially comparable to the wording in section 35 as both require the amounts to be for the exercise/use of a right (although the type of rights differ) and the payment is made to the owner or holder of those rights. Points (3), (4) and (5) would not be comparable as section 35 does not require a link to the quantity of the use, nor is it a requirement that the privilege (e.g. to use the trademark) must be exercised.\(^{29}\) It might be that such a link is required for purposes of other Acts, but for purposes of the ITA, this link is not necessary.

In conclusion, it would appear that the common law meaning of a royalty could differ significantly from its meaning from a SA legislative perspective. The relatively narrow wording used in section 35 (i.e. the use/right to use of a certain type of IP) seems to point at a more limited meaning for SA income tax purposes. Furthermore, the common law definition does not include part 2 of the definition structure (i.e. the impartation of knowledge), as detailed above. This would provide even more support for the necessity of a royalty definition in the ITA.

\(^{29}\)Section 35(1) refers to amounts received for the use or right to use an IP. The wording in section 35 does not indicate that the right must be exercised.
2.5. INTERPRETATION OF THE WORD “ROYALTIES”

2.5.1. Approach taken by courts

As the ITA currently stands, courts could find it difficult to determine whether an amount would constitute a royalty for the purposes of section 7, section 9D or any other section containing the word royalty, as there is currently no definition in the ITA. Furthermore, as was shown above, there is currently no tax case law in SA that defines a royalty. Courts could consider its common law meaning (with reference to foreign cases), but as was shown above, the differences between the common law meaning and the wording in section 35 (as well as the OECD DTA definition) could result in inconsistent treatment of certain amounts. Therefore, the issue to consider is how a court would go about interpreting the meaning of a royalty.

The dominant approach to the interpretation of any statute in South Africa is the so called “literalism-cum-intentionalist” approach.\(^{30}\) In this approach, determining the intention of the legislation is the main objective. However, it is assumed that the intention of the legislature is expressed in the literature and no further investigation is needed.

The “literalism-cum-intentionalist” approach assumes that the language of the statute can be clear and unambiguous. Clear and unambiguous language is believed to be “a “correct” and authentic expression of the intention of the legislature”.\(^{31}\) The so-called ordinary language is often assumed to be the clear and unambiguous language of the legislature. However, the ordinary language in itself is not always clear and unambiguous as it in itself could have multiple meanings.\(^{32}\) Therefore, this approach to interpretation, although dominant, may not be the most effective approach. However, on the basis that this approach is the most dominant in South African judicial practice, it would be worthwhile to attempt an interpretation of “royalties” using the “literalism-cum-intentionalist” approach. Accordingly, the goal here would be to ultimately determine the ordinary language (or ordinary meaning) of the term royalties as used in the ITA.


\(^{31}\) Du Plessis, supra. Note 30, Page 198

\(^{32}\) Du Plessis, supra. Note 30. Page 198 - 199
2.5.2. **Ordinary dictionary meaning**

Dictionaries are often used in courts to determine the ordinary meaning of a term.\(^{33}\)

According to the Dictionary of English,\(^{34}\) a royalty is defined as:

\[
\text{“…. (2) a sum paid to a patentee for the use of a patent or to an author or composer for each copy of a book sold or for each public performance of a work.”}
\]

The South African Concise Oxford Dictionary\(^{35}\) contains the following definition for a royalty:

\[
\text{“…. (2) a sum paid for the use of a patent or to an author or composer for each copy of a book sold or for each public performance of a work.”}
\]

It would appear that the above definitions are more limited than the wording of the various sections of the ITA that (implicitly) refers to a royalty. Specifically, the above definitions collectively encompass payments for the following:

- use of a patent
- to an author for each copy of a book sold
- to a composer for each public performance of a work

It follows that the dictionary definition would only include payments for the use of a patent and a copyright (in respect of payments to an author and a composer). On the basis that the scope of section 35 of the ITA is wider, it is submitted that use of only the dictionary definition would not be suitable for defining a royalty for the purposes of the ITA.

2.5.3. **Intention of Legislature**

The next step is to consider the intention of legislature when inserting the word royalty into the ITA. Section 9D will be considered as an example.

2.5.3.1. **Royalty used in the CFC provisions**

In terms of section 9D(fA), if a CFC receives a royalty from another CFC forming part of the same group of companies, that royalty is exempt from imputation. This specific provision was inserted into the ITA by section 28(1)(h) of the Taxation Laws Amendment Act, 1998 (Act No. 30 of 1998) and at that point in time, referred to amounts “deemed to have accrued to the entity from a source in the Republic in terms of section 9(1)(b) or (bA)”.

This was deleted by section 10(m) of the Revenue Laws Amendment Act, 2000 (Act No. 59 of 2000) (“2000 Amending Act”). In the same amending act, section 9D(fA) as it currently stands was inserted (by section 10(n)) which referred to a royalty as opposed to referring to sections 9(1)(b) and (bA). The Explanatory Memorandum to the 2000 Amending Act stated the following:

“Where the income of the CFE (the current CFC) is derived by way of any ... royalty...such income will also not be imputed to the resident.”

The Explanatory Memorandum uses the word royalty without explaining the meaning of the word (i.e. whether it refers to amounts previously described in sections 9(1)(b) and (bA)).

During this time, SA’s tax system changed to a residence basis of taxation. In this regard, the majority of the deemed source provisions contained in section 9 were deleted by the 2000 Amending Act (including section 9(1)(b) and (bA)). The Explanatory Memorandum to the 2000 Amending Act provided the following explanation for their deletion (at page 16):

“As residents will now be taxed on their worldwide income, there is no need to deem certain forms of income to be from a source within the Republic.”

Therefore, it was necessary to remove the reference to sections 9(1)(b) and (bA) in the CFC legislation as those sections were deleted. However, there was no indication as to whether the word royalty as used in section 9D was to be given the meaning it previously had prior to the 2000 Amending Act.
It is interesting to note that section 9(1)(b) and 9(1)(bA) were re-inserted by section 12(1) of the Revenue Laws Amendment Act, 2002 (74 of 2002). However, the CFC legislation was not amended and still referred to a royalty.

2.5.3.2. Historic amendments made to section 35

Prior to SA changing to a residence basis of taxation, section 35 also referred to section 9(1)(b) and (bA) of the Act. As a result of the 2000 Amendment Act deleting the latter sections, section 35 was amended by the 2000 Amendment Act to incorporate the wording that was contained in the then sections 9(1)(b) and (bA).

What is interesting to note is that the Explanatory Memorandum to the 2000 Amendment Act provides the following explanation for the amendment to section 35 (on page 26):

“Currently section 35 provides for the assessment of non-residents in respect of income derived from royalties or similar payments contemplated in section contemplated in section 9(1)(b) and (bA). These royalties include amounts received by or accrued to such person by virtue of .... It is proposed that section 35 be amended to constitute a final withholding tax of 12 per cent on royalties.”

(underline – own emphasis)

Essentially, it explains that the purpose of the amendment is to incorporate a final withholding tax of 12% on royalties. It does not deal with the identification of a royalty. However, it does refer to the wording of sections 9(1)(b) and (bA) (now incorporated into section 35) as royalties, albeit in an indirect manner.

It is not abundantly clear whether, by referring to the receipt of any of these amounts as a royalty, it was the intention of Legislature to use this meaning as a meaning of a royalty when used elsewhere in the Act. Furthermore, the use of the term “royalties or similar payment” creates the classification difficulty between a “royalty” or a “similar payment”.

With regards to section 7(7) of the ITA, the word “royalty” has always been included in that section (even before the basis of taxation is SA was changed).

2.5.3.3. Proposed amendments to section 35

As mentioned in Chapter 1, an amendment was made to section 35. Specifically, section 35(1) has been substituted in its entirety. As opposed to listing the items that would be
subject to WHT, the revised section 35 merely refers to the new source rules pertaining to royalties (i.e. section 9).

A definition for “royalty” for the purposes of section 9 has also been introduced into the ITA. The new definition defines a royalty as an amount received for the use of intellectual property as defined in section 23I. The definition of intellectual property in section 23I is very similar to the property listed in the current section 35 of the ITA (and includes knowledge connected with the use of that property). Furthermore, consistent with the current wording of section 35, the definition of intellectual property in section 23I does not correspond with the common law definition of a royalty (per Woellner’s summary) in that there is no linkage between the amount of the royalty and the usage of the intellectual property (as explained in 2.4.4). Therefore, there does not appear to be any change in the items that would be subject to section 35 nor are there any changes in the principles of the source rules for royalties. As pointed out in 2.2.2.3, the current wording of the deemed source provisions for royalties is almost identical to the current section 35 and therefore a duplication exists for the wording commonly used to describe a royalty.

From this it can be drawn that the purpose of the proposed amendment to section 35 is to remove this duplication, rather than changing the nature of the amounts subject to section 35. On this basis, it is submitted that this proposed amendment will not affect the conclusions draw in this dissertation.

In addition, the above introduction of a definition for “royalty” is specifically for the purpose of section 9 (and indirectly for section 35). On this basis, it is submitted that this proposed amendment will not affect the relevance of this dissertation as the word “royalty” is still used in various other sections of the ITA (e.g. section 7), without a corresponding definition. In any event, the new definition may not be sufficient in addressing whether an amount is for the “use” of an identified IP and therefore a royalty (see 2.3.2.2 above for more detail on this issue).

2.6. CONCLUSION

The purpose of this chapter was to obtain a meaning for the word royalty used in the ITA at various points, as it is not defined in the ITA. It was determined that the ITA uses essentially the same wording to describe what would commonly constitute a royalty, the
main section being section 35 which describes amounts subject to withholding tax on royalties. The question was whether the wording of section 35 of the ITA should be used as the meaning of the word royalty used in the ITA.

The OECD DTA does contain a definition for a royalty and this definition is comparative to the wording contained in section 35 of the ITA. Furthermore, the commentary to the OECD DTA appears to align the OECD DTA definition with the wording of section 35. Therefore support can be drawn from this for the use of section 35 as the meaning or definition of a royalty for SA tax purposes.

On the basis that the term royalty is not defined in the ITA, the courts in SA may use the common law definition in defining a royalty. However, it would appear that the common law definition would, broadly speaking, only encompass part 1 of the definition structure in 2.2.3. above (i.e. amounts received for the use of an IP). Furthermore, the common law definition is much wider and does not correlate with the wording of section 35. This could result in inconsistencies in the classification of receipts.

A literal interpretation of a royalty would limit its application severely and, similar to the common law, could result in inconsistencies in the classification of receipts.

Furthermore, it is not clear whether it was the intention of the legislature that the wording contained in section 35 should be the “official” definition of a royalty, despite mentioning in the Explanatory Memorandum that the purpose of the section is to assess royalties received by non-residents.

It is submitted that, due to all these uncertainties, a definition should be introduced into the ITA. This definition should be based on the wording used in section 35 (as it is most comparable with the OECD DTA definition).

However, as mentioned above, there are differences in the wording of section 35 and the OECD DTA definition. The remainder of this dissertation will take a closer look on the effect of those differences (to ascertain the SA application of its DTA network) and whether the wording in section 35 should be aligned to the OECD DTA definition.
CHAPTER 3: DISTINGUISHING KNOW-HOW FROM SERVICES RENDERED

3.1. INTRODUCTION

In chapter 2, one of the differences noted in the wording between section 35 of the ITA and that of the OECD DTA definition of royalties, is that the latter does not specifically refer to amounts for assistance or services rendered in connection with the application or utilisation of any knowledge or information.

As mentioned previously, this difference could result in the double taxation of an amount received for providing such assistance or services, to the extent that relief is not attainable elsewhere in the DTA. This issue can be illustrated by means of the following example.

3.1.1. Illustrative example of issue

A non-resident company owns a registered patent which it uses to manufacture electronic devices sold in its country of residence. This non-resident company is approached by a SA resident company requesting permission to use this patent to manufacture and sell these electronic devices in SA. In this regard, the non-resident company has agreed to do the following:

(1) Allow the SA resident company to use that patent to manufacture the electronic devices in SA;

(2) provide information to the SA resident company in respect of the use of that patent in the form of instruction manuals and specifications; and

(3) provide assistance in respect of using that patent by providing training to the employees of the SA resident company.

In terms of section 35 of the ITA, amounts received by the non-resident company in respect of all the above will be subject to WHT at 12%. In addition, the non-resident company is likely to be taxed on the same amount in terms of its country’s domestic legislation. Accordingly, the non-resident company may be taxed twice on this amount and in order to obtain relief (and assuming for purposes of this example that there is no
relief in the non-resident state’s domestic legislation), the DTA between the non-resident’s state and SA would need to be used.

Let’s further assume that the DTA between the non-resident state and SA follows the OECD DTA exactly. In this regard, does the amount received by the non-resident company fall in Article 12: Royalties?

Based on the DTA, the amount in respect of point (1) above would fall within Article 12 as this amount is for the use of a patent.

Article 12 also defines a royalty as amounts received for “information concerning industrial, commercial and scientific experience”. Based on the wording of this Article, it is safe to say that point (2) above would also fall into article 12 as the non-resident company has received an amount for providing information concerning the use of the patent (i.e. arguably scientific experience).

However, Article 12 does not make specific reference to assistance or services rendered in respect of the use of that information. It merely refers to amounts for “information regarding ... experience”. On the assumption that amounts for assistance or services rendered are not included in the scope of this wording, the amount received by the non-resident in respect of point (3) above (i.e. training provided) would not fall under article 12, despite being subject to WHT in terms of SA domestic legislature. This could result in double taxation if these “services rendered” are not covered elsewhere in the DTA e.g. Article 7 (Business Profits) to the extent that the payment of the services rendered are derived from an asset connected to a business establishment; as well as Article 15 (Income from employment) and Article 21 (Other income) to the extent that the requirements in those articles are met.

The purpose of this chapter is to consider whether the phrase “information regarding ... experience” as used in the OECD DTA includes an element of services or if not, whether it would be necessary to align the wording of section 35 to that of the OECD DTA to avoid the risk of an amount being classified as something other than a royalty.
3.1.2. **Relevance of know-how**

Prior to analysing know-how, it is important to understand its relevance in the context of royalties and the purpose of specifically including it in the WHT on royalty regime for most countries.

Agreements allowing for the use of IP (e.g. licensing agreements) would typically include provisions for the transfer of knowledge or information (i.e. know-how) by the owner or holder to the user of that IP. This is usually prevalent in patent licensing agreements where, as demonstrated in the example above, the licensee would receive the right to use the secret manufacturing process and in addition, receives information and knowledge from the licensor on using this process. It would be hard to imagine a situation whereby the licensee would receive a right to use a secret manufacturing process without any instructions or directions from the licensor on how to use that manufacturing process (unless the manufacturing technique is simple in nature). In fact, it was reported that at one stage, approximately 62% of licensing agreements included provisions relating to know-how.\(^36\) Therefore, it is very common that when technology is transferred (e.g. in the form of licence agreements), it is accompanied by the know-how relating to the technology being transferred.

It is likely due to this that the WHT on royalty regime, both for purposes of the ITA and the OECD, specifically includes know-how.

3.2. **Wording of Section 35 of the ITA Relating to Know-How and Its Misalignment with the Corresponding Definition of Royalties in the OECD DTA**

Section 35 of the ITA contains the following wording in paragraph 1(b):

“the imparting of or the undertaking to impart any .... knowledge or information for use in the Republic, 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”

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The first part of this provision encompasses the imparting of knowledge or information. As mentioned above, this knowledge has commonly been referred to as “know-how”. The second part of this provision encompasses assistance or services rendered in connection with the knowledge or information imparted and has been to some extent referred to as “show how”.

To summarise, section 35(1)(b) of the ITA covers amounts for:

- Imparting of know-how; and
- Show-how.

The “corresponding” provision in the OECD DTA definition of royalties is as follows:

“payments .... for information concerning industrial, commercial or scientific experience.”

It is generally accepted that this wording covers payments for the impartation of know-how. However, it is not clear whether it covers amounts for show-how (i.e. the second bullet point above). Therefore, the crisp issue is whether show-how should be considered as part of know-how (in which case it would be covered by Article 12 of the OECD DTA) or whether it should be considered purely as services rendered and accordingly, not included in the OECD DTA definition of royalties.

As a starting point, the terms “know-how” and “show-how” should be understood before deciding whether “show how” would fall part of know-how or whether it should merely be classified as services rendered.

3.3. KNOW-HOW

It is not necessary to define the term know-how, as this term is not used in the ITA, neither is it used in the OECD DTA. Rather, an understanding of the nature of “know-how” will assist in determining what the impartation thereof entails. In other words, what action is required in order to impart this know-how?

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37 Silke, AS et al. 1974. The Taxation of ‘Know-How’. The Income Tax Reporter. 13(97): 1 - 32 where on page 1 the author referred to this knowledge as “know-how”.

38 Paragraph 11 of the commentary to Article 12 confirms that this part of the definition refers to know-how and that in order to use this know-how, one party would need to impart the know-how to the other party in a know-how contract (paragraph 11.1).
Should it be determined that the act of imparting know-how would include the provision of assistance or rendering of service, this may imply that specific reference made to services rendered in section 35 of the ITA could be redundant. In this regard, the reasoning for the specific inclusion of show-how in section 35 will also be investigated.

3.3.1. Dictionary definition

As there is no need to define the term “know-how”, it is not necessary to go through the formal steps undertaken in the process of defining the term royalties in chapter 2. Therefore, it would be acceptable to go directly to the dictionary definition of this term.

According to the South African Concise Oxford Dictionary,\(^39\) know-how is defined as “expertise” and is classified as a noun. The Dictionary of English\(^40\) defines know-how as “practical knowledge or skill; expertise”.

The definition provided in Black’s Law Dictionary is slightly more descriptive. It defines “know-how” as “The information, practical knowledge, techniques, and skill required to achieve some practical end, esp. in industry or technology” and further states that: “Know-how is considered intangible property in which rights may be bought and sold.”\(^41\)

Therefore, the above dictionary meanings confirm the general understanding of know-how, being some sort of expertise or knowledge. However, the definition in Black’s Law Dictionary also refers to know-how being an intangible asset, the rights of which are capable of being bought and sold. There is no indication that the knowledge, techniques etc. would need to be registered first in order for the right therein to be bought or sold. This would differ from more conventional intangible assets which are capable of being bought and sold themselves, such as a registered trademark.

The definition in Black’s Law Dictionary also refers to “trade secrets”. This supports the notion of know-how being an intangible asset of that company as generally “trade secrets” is something that a company owns, although not from a legal perspective (i.e. if that trade


secret is leaked to a competitor, that competitor is free to use that information as they please).  

### 3.3.2. SA case law

It is also important to obtain an understanding of know-how from a tax perspective. Although not included in the ITA, the term know-how has been the subject of numerous income tax cases (in SA and internationally).

In Income Tax Case 1190 the Transvaal Special Court was called upon to decide whether the income earned from the sale of know-how was of a capital or revenue nature. Although this specific case dealt with the income earned on the sale of know-how (as opposed to the know-how itself), the judge went into great detail on the meaning and nature of know-how.

This case involved a SA resident company (the appellant) carrying on business as manufacturer of specialised machinery for sale. The appellant registered the invention of one of its machines that it manufactures and sells. Thereafter it was approached by a foreign manufacturing company who wanted to manufacture and sell this machinery overseas. In this regard, the appellant entered into a contract with the foreign manufacturer for the sale the invention (as was worded in the contract). This related to the drawings, specifications and other relevant documents which were transferred to the foreign manufacturer in terms of the contract. In addition, the employees of the foreign manufacturer were sent to SA to receive instructions from the appellant’s employees. The issue was whether the proceeds from the sale of the “invention” were of a capital or revenue in nature. The main argument from the appellant was that it was not involved in the trade of inventions and accordingly, the receipt of the sale of this “invention” should be capital.

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42 Correa, CM. supra. Note 36. At page 471, where the author specifically states that know-how is unlike patented technology in that the possessor of know-how is unable to prevent that know-how from being used by third parties.

43 ITC 1190 (1970) 35 SATC 188(T)
The court referred to various English cases regarding the nature of know-how. At 191, while referring to the judgement in the English case *Evans Medical Supplies Ltd v Moriarty (HM Inspector of Taxes)*, Galgut J said the following:

“Firstly they held that know-how was a capital asset despite the fact that it differed from capital assets such as buildings and goodwill in that when the latter assets are sold the taxpayer divests himself thereof whereas when know-how is sold the taxpayer retains the assets as a rule...”

Galgut J also cited another English case *Jeffrey (HM Inspector of Taxes) v Rolls-Royce Ltd* and stated the following at 192:

“The House of Lords held that the proceeds for the know-how were of an income nature. In so doing the learned judges discussed the character of know-how. They ... held that it was a capital asset or analogous to a capital asset. However it was held that the sale of such an asset did not mean that the proceeds constituted a capital receipt ... by parting with know-how a taxpayer did not divest himself of his capital asset.”

In coming to his judgement, Galgut J referred to the following dicta of Lord Denning in the *Evans Medical Supplies* case at 589 regarding the nature of know-how:

‘What, then, is the position of know-how for tax purposes? It is undoubtedly a revenue-producing asset. The possessor can use it to make things for sale, or he can teach it to others for reward. But he cannot sell it outright. It is rather like the know-how of a professional man. He can use it to earn fees from his clients, or he can teach it to pupils for reward, and so produce revenue. But he cannot sell it as a capital asset for a capital sum. He cannot sell his brains. So with a company which has special manufacturing skill and experience but has no secret processes. Its know-how is inseparable from the know-how of its staff and servants. It cannot prevent them using it any more than it can prevent them using their own brains ... It cannot sell it as a capital asset. It can only use it or teach it. Even with a company which owns secret processes, the supply of know-how is not like the sale of goodwill or a secret process, for such a sale imports that the seller cannot thereafter avail himself of the special knowledge with which he has parted ... and it may then rightly be regarded as the sale of a capital asset... But the supplier of know-how always remains entitled to use it himself, as was the case here.’

Galgut J also referred to the following dicta by Lord Denning in *Musker (HM Inspector of Taxes) v English Electric Co Ltd* at 582 where the following was stated:

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44 (1957) 37 TC 540
45 (1962) 40 TC 443
46 (1964) 41 TC 556
“Know-how is an intangible asset, just as intangible as goodwill and just as worthy of recognition. It is a revenue-producing asset, just as goodwill is.”

As the final judgement in *ITC 1190* is not relevant for the purposes of this dissertation, it is not discussed further here. Rather, *ITC 1190* has made some important points on the nature of know-how. These points can be summarised as follows:

- Know-how is a capital asset;
- It is an intangible asset;
- It can be used by the owner either to produce items for sale or to teach it to others for reward; and
- It cannot be sold as the owner will always be able to use it (e.g. one cannot sell his brains).

3.3.3. **International definitions and understanding of know-how**

3.3.3.1. **OECD DTA Commentary**

The commentary to Article 12 of the OECD DTA, when referring to this aspect of the royalty definition (i.e. information relating to experience), states that the wording in the definition should be used “in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights”. The commentary also refers to know-how as “undivulged information for an industrial, commercial or scientific nature arising from previous experience”.

Therefore, the commentary refers to know-how as unpatented knowledge or previous experience. The commentary also states that this knowledge can be transferred and this implies that the knowledge in question is something that is owned by one person (as one would need to be in possession of something in order to transfer it). This is in line with the judgement in *ITC 1190* regarding the nature of know-how (i.e. being an intangible capital asset).

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47 Paragraph 11 of the OECD DTA commentary to Article 12
48 Paragraph 11 of the OECD DTA commentary to Article 12
3.3.3.2. **Know-how as used in contracts**

In “Legal Nature and contractual conditions in know-how transactions”⁴⁹ a study was undertaken in an attempt to understand the nature of know-how as used in contracts.

The study described the definition of know-how as being “a most controversial issue” in that different jurisdictions would ascribe varying definitions or understandings to the term. Some jurisdictions would refer to know-how simply as a “trade secret” whereas other jurisdictions would include commercial information relating to the operation of an enterprise into its definition or understanding of know-how.⁵⁰ Furthermore, know-how has also been referred to as “unpatented technology”.⁵¹ The following description of the term know-how was provided in the study:

> “know-how can be described as the method of manufacture or the technical knowledge relating to the use and application of industrial technologies”.⁵²

Although there is nothing new in this description that has not been discussed before, an interesting point noted in the study was the distinction of the definition / understanding of know-how in developed countries as opposed to developing nations. It pointed out that, as developing countries tend to have a higher dependence on foreign technology, this influenced the definition / understanding of know-how in those countries.

### 3.3.4. **Characteristics of know-how**

Based on the above analysis, there are certain key characteristics of know-how which appears to be relevant whether the term is used in SA or in other jurisdictions.

Firstly, know-how relates to knowledge or experience which may or may not be secretive in nature. It is unlikely that this knowledge or experience is registered or patented. In this regard, there are no limits or “boundaries” on the knowledge or experience that would constitute the owner’s know-how.

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⁴⁹ Correa, CM. *supra*. Note 36
⁵¹ Correa, CM. *supra*. Note 36. At page 455
⁵² Correa, CM. *supra*. Note 36. At page 463
Secondly, based on the judgement of *ITC 1190*, know-how is an intangible capital asset and therefore capable of being owned. However, because it is likely not to be patented or as protected as patented IP, other parties may legally use this know-how with or without the owner’s permission.

Finally, know-how may be used to generate revenue for its “owner”, either by using it himself to improve the efficiency of operations etc. or by allowing others to use this “know-how” for a fee (i.e. to impart that know-how).

### 3.4. SHOW-HOW

#### 3.4.1. Definition

Unlike know-how, the term show-how is not commonly used and therefore it is not necessary to obtain a definition or an understanding of this specific term. Rather, for the purposes of this dissertation, show-how will be used to denote the following wording contained in section 35 of the ITA:

> “... the rendering of or the undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information”

Therefore it is this wording that needs to be analysed to specifically determine the type of assistance or service that are covered.

#### 3.4.2. Characteristics of show-how

Based on the wording of show-how, it is clear that the assistance or services must be in connection with the application or utilisation of the know-how. The use of the wording “in connection with” already places a restriction on the scope of the assistance or services. Simply put, any assistance or services that are not connected with the application or utilisation of the know-how will not fall within section 35 (and therefore it would not be necessary to seek relief in terms of Article 12 of the OECD DTA as the amount would not be subject to WHT in SA).

The issue is then to determine exactly what assistance or service would be considered to be in connection with the application or utilisation of the know-how being imparted. These services would be subject to WHT in SA in terms of section 35.
3.4.2.1. Services resulting in the imparting of further knowledge

In an article of “The Income Tax Reporter”\(^\text{53}\) this issue was considered and the following was stated on page 4:

“The services must be in connection with the application or utilization of the ‘know-how’. Payments for instruction in the application of the ‘know-how’ or payment for undertaking to keep the user of the ‘know-how abreast with current technical developments would thus be embraced by the new provisions. Since the services must be in connection with the ‘know-how’ it would seem that the services must themselves be in the nature of the imparting of further ‘know-how’ connected with the ‘know-how’ described in the provisions”.

According to the above, show-how specifically includes:

1) the provision of instructions (e.g. presenting the instructions to the users of the know-how as opposed to merely handing over the instruction manual);

2) services for keeping the recipient abreast with new knowledge; and

3) in all cases, services with the effect of imparting further know-how.

Technically speaking, the provision of instructions (point 1 above) would not be considered as imparting know-how. However, when receiving instructions on how to use knowledge or information received, one could say that additional knowledge is being obtained (on how to use that knowledge or information). Accordingly, this in itself could possibly be including in the OECD DTA’s scope of imparting know-how.

It is arguable that services for keeping the recipient abreast with new knowledge (point 2) will constitute imparting of know-how as these services have the effect of imparting further knowledge. Had these services been provided to a different recipient (to whom know-how has not yet been previously imparted), it could easily be classified as imparting or know-how.

In any event, point 3 states that in all cases, the services should have the effect of imparting further know-how. In this regard, it is submitted that all the services listed above would fall within the scope of Article 12 of the OECD DTA as they would be

\(^{53}\) Silke, AS et al. supra. Note 37
included in the imparting of know-how provision and there would be no issue in this respect.

However, this is only one view of the type of services included in show-how. There is no requirement in section 35 that the assistance or services must have the effect of imparting further know-how and accordingly, show-how could include those services that do not have this effect.

3.4.2.2. Direct causal link

An article in *Juta’s Income Tax* indicated that the use of the wording “in connection with” in section 35 meant that “[a] direct causal link is required” between the assistance or service and the application or the utilisation of the knowledge or information in question.

The wording “direct causal link” has been considered in *Stander v Commissioner for Inland Revenue* where a similar phrase (i.e. causal relationship) was analysed.

The *Stander*’s case involved an accountant of a dealership whose duties included the preparation of monthly financial reports. The dealership had entered into an agreement whereby it would furnish these monthly reports to *Delta Motor Corporation (Pty) Ltd* (‘*Delta*’), of which the dealership was a franchisee. During the tax year in issue, the accountant was awarded a prize by *Delta* consisting of an overseas trip. The prize was in recognition of excellent standards of financial management. The issue brought before the court was whether this prize should be included in the accountant’s gross income.

It was accepted that the prize was of a fortuitous nature and therefore capital in nature. Accordingly, it could not be included in the opening paragraph of the ‘gross income’ definition in section 1 of the ITA. One of the arguments made was that the amount received falls within para (c) of the ‘gross income’ definition in that it was ‘in respect of service rendered’. Friedman JP, who gave the judgement in this case, relied on previous judicial decisions on the meaning of ‘in respect of’ and concluded that this meant ‘causal relationship’. Accordingly, there had to be a causal relationship between the amounts received and the services rendered. In this regard, Friedman JP said the following at 220:

55 (1997) 59 SATC 212
“The fact that Stander was an employee of Frank Vos Motors, was a sine qua non to his receiving the award. Had he not been an employee of a Delta franchise holder he would not have been eligible to receive the award. That fact does not, however, provide the necessary causal link between the services which he rendered to his employer and his obtaining of the award. Those services did not constitute the causa causans of the award. He did not seek the prize by entering a competition (...........) Nor did he expect to receive anything from Delta for the work he performed for Frank Vos Motors. He merely performed his normal duties for which he was remunerated by his employer. The fact that these duties were performed in a manner which Delta considered to be excellent was what qualified him to receive the prize.

In addition, Freidman JP referred to an English case\textsuperscript{56} where the captain of the English soccer team received a bonus for winning the world cup. It was held that this bonus was not taxable as it was not a payment for remuneration of services rendered (during the world cup) but rather as a testimonial or an accolade (for exceptional performance).

In conclusion, Friedman JP stated the following at 212:

“The fact that these services were beneficial to Delta does not mean that the award he received was ‘in respect of’ services rendered. The sine qua non referred to above does not provide the necessary causal link between what Stander did and the award he received.”

It appears that the principal emanating from the above is that there must be an intent or purpose present. The employee in the Stander case did not seek the prize while rendering his services and therefore the purpose of that payment was not for his service rendered, but for the quality of the services rendered. Likewise, the purpose of the payment to the soccer captain was not for the services he rendered during the World Cup, but merely for his participation in the World Cup.\textsuperscript{57}

West (2009)\textsuperscript{58} also considered the requirements of a “causal link”. It was submitted that only the immediate or dominant cause is relevant for identifying the direct causal link and states, on page 50, that “while a number of related causes may have influenced the receipt, the question to be answered is: what is the immediate cause?”. The receipt referred to here was the receipt for non-resident sportpersons and the issue is whether this receipt would

\textsuperscript{56} Moore v Griffiths (Inspector of Taxes) (1972) 3 All ER 399 (48 TC 338).

\textsuperscript{57} Moore v Griffiths. Supra. Note 56. At 411, Brightman J stated the following: “The true purpose of the payment was to mark his participation in an exceptional event, namely, the winning of the World Cup Championship”. In other words, the purpose of the payment was not the service rendered during the World Cup by the captain, but rather for participating in an exception event.

\textsuperscript{58} West, C. 2009. The Taxation of International (non-resident) Sportpersons in South Africa. Thesis. Department of Accounting, University of Cape Town.
be subject to WHT in terms of sections 47A – 47K of the ITA. Essentially, West submits that it is possible to have many causes influencing an outcome (e.g. receipt for non-resident sportspersons) but it is only the immediate or dominant cause which gives rise to the causal link.

If the above principles are applied to show-how, it may be said that firstly the assistance or service rendered must have a purpose namely, for the use of the know-how by the recipient, before it can be considered as show-how. Secondly, it must be the immediate or dominant purpose. In other words, it must by the most dominant purpose for there to be a causal relationship. So in determining whether the assistance or service in question has a causal link to the use of the know-how, the questions to ask are:

1) Is the purpose of that assistance or service specifically for use of the know-how imparted?

2) Is that purpose the immediate/dominant purpose?

There may be a dual purpose for the assistance or services. For example, the purpose may be to show the recipient how to use the know-how and also to help the recipient in using that know-how in that recipient’s business (to improve the recipient’s effectiveness). The question that needs to be asked is which one is the immediate/dominant purpose or rather, which one is the most dominant purpose? If the dominant purpose is the former in the above example, this would be show-how. However, if the dominant purpose is the latter, this would not be show-how, but rather services rendered.

There are without a doubt, many cases where this separation is blurred and each case would need to be decided on its own set of facts. However, if the most dominant purpose of the assistance or service is for the use of know-how imparted, there will be a causal relationship between the two and therefore, the assistance or service will be “in connection with” the use of that know-how and accordingly, will be included in section 35.

3.4.3. **Purpose for including assistance or services rendered**

It would be helpful to understand the purpose of specifically including show-how into the WHT on royalties regime (for SA purposes). This may give an indication of the type of services that the legislature had in mind when introducing show-how.
The first point of reference in determining legislature’s purpose would usually be the explanatory memorandum accompanying an amending act. However, at the time of inserting show-how into the ITA, the then SA revenue authorities did not issue any accompanying explanatory memoranda. Accordingly, the purpose of including show-how would need to be sought elsewhere.

3.4.3.1. Dependence of foreign IP in developing nations

SA’s status as a “developing nation” may provide clues as to the purpose of including show-how into the ITA. In Correa’s study, statistics were provided on the international trade / transfer of technology. The study indicated that in 1977, it was estimated that approximately one billion U.S. dollars flowed into the U.S.A. as a result of the transfer of know-how alone.  

It is understood that this estimate excluded fees for the licensing of registered patents or trademarks.

As mentioned above, the study also indicated that, based on a sample of licensing contracts that were concluded during the period 1962 to 1970, 62% included know-how.

Although outdated, using statistics during this time period is relevant for determining the purpose of specifically including show how into section 35 of the ITA as this is the period when this specific provision was first introduced into the ITA. These statistics indicate the size of trade / transfer of know-how at the time when show-how was introduced into the ITA.

With regards to developing nations, the study found that know-how and other unpatented technologies were more important as a component of the transfer of technology in those nations than in developed nations. In this regard, the following was stated in the study

“Enterprises in developing countries frequently lack the technical skills and infrastructure needed to introduce new processes and products. Technology transfer in this context often involves a set of supplies and services, including technical information (process description, formulae, instructions, etc.), training at supplying parties’ plants, technical assistance, quality control methods, and so on”.

59 Correa, CM. supra. Note 36. At page 452
60 The know-how and show-how provisions were introduced into the ITA by section 4(1)(c) of the Income Tax Act, No.65 of 1973
61 Correa, CM. supra. Note 36. At page 455
This implies that, if a company in a developed nation (such as the USA) enters into a patent licence agreement with another company in a developing nation (such as Kenya) to grant the latter company the right to use that patent, it is more likely than not that additional supplies or services will be required from the developed nation in order for the developing nation to effectively use the patent. Had the agreement been entered into between companies in developed nations, it is more likely that the agreement would only entail the granting of the right to use the patent accompanied by an instruction manual (without further involvement by the owner / holder of the patent).

Therefore it would appear that the degree of assistance or services required by a developing nation in using a patent that it has “imported” would be far greater than that required by a developed nation. As SA is considered to be a developing nation, this may have likely influenced the decision to specifically include show-how in section 35 of the ITA.

It is interesting to note that, although the statistics used in the above analysis are outdated, the UNs 2001 document emanating from its conference on Trade and Development entitled “Transfer of Technology”\(^\text{62}\) states that the acquisition of technology by developing countries is a necessity to further the development of that developing nation. Accordingly, the dependence of foreign technology to developing nations is currently still a hot topic.

3.4.3.2. **SA tax implication of foreign licensors**

SA has a resident and source basis of taxation. Residents are taxed on their worldwide income whereas non-residents are taxed on income with a source or deemed source in SA.

When a non-resident earns income from a SA source, income tax will be levied thereon in terms of section 5(1) of the ITA. Payment of such income tax would normally be in the form of provisional tax or assessed tax (once the taxable income of that non-resident has been assessed by the SARS). However, demanding payment from a non-resident can be quite difficult especially when there is a dispute (e.g. such as a dispute on whether the source of the income is from SA or not) as this may likely require the involvement of both countries’ governments. Therefore, to avoid such scenarios, (as well as for many other reasons), a WHT system is put in place that essentially places the obligation on the

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resident to withhold an amount from the payment to a non-resident, which would in the majority of cases constitute a final tax. As the obligation is placed on the resident, this would make the demand for payment of tax much easier for the SARS.

In terms of the ITA, amounts received for the use of certain IP or for the impartation of know-how is deemed to have its source in SA if that IP or know-how is used in SA. When the amounts are paid to non-residents, the payments would be subject to SA’s WHT on royalties regime, being section 35 of the ITA and this is essentially a final tax. This will avoid the situation whereby SARS would need to demand payment directly from the non-resident (which, as explained, may be difficult).

The income earned by the non-resident on show-how will have its deemed source in SA if the related know-how is used in SA (in terms of the ITA). In this instance, the income earned thereon will be subject to income tax in SA. However, as stated above, demanding payment of tax from a non-resident may prove difficult unless a WHT system is put in place. This would be particularly important for developing nations (such as SA) where agreements involving the transfer of technology (such as licensing agreements) would include a higher degree of assistance or services than that of developed nations.

It follows that the portion of the consideration paid to the non-resident relating to show-how would be higher for developing nations than that of developed nations (as more effort will be required than simply handing over documents from the non-resident in terms of the relevant agreement).

It is with this in mind that the legislature may have wanted to ensure that show-how was specifically included in the WHT on royalties regime in SA to ensure that all amounts relating to show-how are included in the amount withheld by the SA resident. There is no “WHT on services rendered regime” in SA and, had show-how not been specifically included in section 35, the amounts related thereto would likely have been taxed in terms of the general gross income principles and the difficulties surrounding the demand and collection of taxes from non-residents may be present.

The specific inclusion of show-how into SA’s WHT on royalty regime is misaligned with the concept of royalty for the purposes of DTAs. This misalignment has led to the current
uncertainty of whether the DTA’s royalty definition applies to SA’s show-how, which is considered next.

3.5. **IMPARTATION OF KNOW-HOW**

Now that know-how and show-how have been analysed, the next step is to determine how this know-how would be imparted (for the purposes of the OECD DTA definition) and whether its scope would extend to show-how.

As mentioned above, know-how is knowledge or experience that is capable of being owned in the form of an intangible asset, which may or may not be patented / protected. The owner or holder of this know-how may impart this know-how in return for a fee. It is also common for know-how to be imparted as part of a patent licence agreement (or some other IP licence agreement). So the question is, how does one impart this know-how?

On one end of the scale, this may involve the mere disclosure of information by means of physically handing over documents containing instructions or specifications, with no further interaction.

On the other end of the scale, this may involve, in addition to the physical hand-over of these instructions or directions, the continuous provision of training and demonstrations to the users of the know-how being transferred.

3.5.1. **Meaning in terms of the OECD DTA**

3.5.1.1. **Transfer of knowledge**

Paragraph 11 of the commentary to Article 12 of the OECD DTA deals specifically with know-how and its impartation. It emphasises that the imparting of know-how is distinct from the provision of services and acknowledges the need to distinguish between payments for the two.

In this regard, it is noted in the commentary that payments for (the transfer of) knowledge or experience that already exists is likely to be a know-how payment. However, payments for any services rendered where no knowledge is transferred cannot be said to be know-how payments.
This distinction may not always be simple as it may not be clear as to whether the knowledge in question already existed, or whether knowledge has been transferred, as it is likely that the knowledge has not been registered or patented (and therefore this is no formal record-keeping of the knowledge). Accordingly, this should only be one factor to consider in determining whether a payment made is for know-how or for services rendered.

3.5.1.2. Level and nature of activity

There is no question that the impartation of know-how would require some sort of activity from the supplier of that know-how, even if this activity would constitute merely sending an email to the recipient with the necessary know-how (e.g. set of instructions) attached. However, it is the level, as well as the nature, of that activity that may jeopardise its classification as being the impartation of know-how.

With regards to the level of activity, the commentary states that in most cases, very little is required by the supplier to impart know-how, other than supplying or reproducing existing information or knowledge. This comment would appear to imply that very little (almost bare minimum) activity is required. However, the supplier is still required to supply or reproduce that existing information (i.e. some activity is still required).

With regards to the nature of activity, the commentary provides examples of the type of services that would not constitute the imparting of know-how. These exclusions include services such as after-sales services and pure technical services.

It follows that the Commentary does not provide concrete guidance on the level or nature of the activity that would be “allowed” for the activity to constitute imparting of know-how. Therefore, guidance would need to be sought elsewhere. However, in providing a list of services that would be excluded from Article 12, as opposed to excluding all services, the commentary essentially confirms that the impartation of know-how may include an element of service and is not limited to mere disclosure.
3.5.1.3. **Mixed contracts**

The Commentary recognises that existence of so-called “mixed contracts” covering both know-how and technical assistance.\(^{63}\) For these “mixed contracts”, the Commentary recommends that the “mixed contracts” be broken down into its individual parts and to apply the appropriate tax treatment to those parts. However, the commentary states that if one aspect of the contract constitutes “by far the principle purpose” of the agreement (with the other aspects merely being ancillary to that purpose), then the appropriate treatment that would have been applied to that purpose should be applied to the entire contract.

For example, if an agreement is entered into whereby one person agrees to provide the a user of a patent with the necessary information and knowledge to use that patent and in addition provides a demonstration (which is likely to take a few hours of the providers time), then an argument can be made that the impartation of that information and knowledge is by far the principle purpose of the agreement, with the demonstration being ancillary to that purpose. Accordingly, the full consideration would be included in the scope of Article 12.

Although the nature of the services may impact on the determination of whether or not those services may be regarded as imparting know-how (i.e. if the services constitute one that is excluded as mentioned in 3.5.1.2, it would not be regarded as such), it would appear that the level of services may be the overriding factor. For example, if an agreement is entered into, with the principal purpose of being “by far” the imparting of know-how, and that agreement includes the provision of “pure technical services” as an ancillary clause to the entire agreement, then, in line with the commentary, the full consideration for that agreement may be classified as consideration for know-how, even though “pure technical services” has been specifically excluded.

On this basis, it is submitted that, for the purposes of the OECD DTA definition, the deciding factor for determining whether any service forming part of an agreement for imparting know-how would itself be classified as imparting know-how (and therefore included in the scope of the OECD DTA definition) is the level of that service in relation to the entire agreement. If the service in question is merely ancillary to the entire

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\(^{63}\) Paragraph 11.6 of the OECD DTA commentary to Article 12
agreement (regardless of its nature), with the principle purpose of being “by far” the impartation of know-how, the service would itself be classified as imparting know-how.

3.5.2. **Meaning from a SA perspective**

It is important to determine how the term “imparting of know-how” would be interpreted by the SA courts where SA’s WHT rate is in dispute. In other words, a non-resident would need to prove to an SA court that, for example, a particular activity constitutes imparting know-how and therefore is included in Article 12’s definition.

As mentioned previously, although not a member of the OECD, SA enjoys observer status and accordingly, is likely to be influenced by the OECD commentary (considered above). However, the commentary may only play an influential role and the courts would turn to any existing judicial precedent first.

Because of the specific inclusion of show-how into the provision of section 35 of the ITA, one could possibly conclude that the term “imparting of know-how”, from a SA perspective, is limited to mere disclosure of that know-how, without any form of services from the provider. Therefore, notwithstanding the commentary to Article 12, there is a real risk that a SA court may hold that the term “imparting of know-how” is limited to disclosure and accordingly, any amounts received for the rendering of any type of assistance or service would not be included in Article 12.

However, there is domestic literature that indicates that this is not necessary the case.

3.5.2.1. **Income tax reporter**

Currently, there are no SA court judgements dealing specifically with the scope of the term “imparting of know-how”. However, *The Income Tax Reporter* 64 provides some indication of what this could entail.

While dealing with the source of know-how, the following was stated on page 38:

> “... the ‘know-how’ may have been developed in a particular place and yet the developer may impart the ‘know-how’ elsewhere. He may have a research department in the Republic and yet may personally impart the ‘know-how’ that he has developed in another country, say, at the premises of a

64 Silke A. *supra*. Note 37. At page 38.
licensee where he conducts regular training courses or is available on certain occasions in a consultative capacity... For example, if the payment for the ‘know-how’ is based on the actual time spent by the ‘developer’ with the licensee’s personnel in the country where the courses and consultations are conducted, it may well be that the source will be located in that country.” (own emphasis).

Although dealing with a different issue (i.e. the source of the know-how), the learned author has by implication, indicated that the term “imparting of know-how” is not limited to mere disclosure and does in fact include services.

3.5.2.2. Ordinary meaning of “impart”

As mentioned previously, SA courts will look at the ordinary meaning of a term in the absence of any other statutory or judicial interpretation.

According to the South African Concise Oxford Dictionary, impart is defined as:

“communicate (information)”

The definition of impart in the Dictionary of English reads as follows

“.... make (information) known: the teachers imparted a great deal of knowledge to their pupils...”

Based on the above definitions, it would appear that the ordinary meaning of the word “impart” is very wide. To “communicate information” or to “make information known” may require more action that simply to “disclose” information. However, more importantly, the definition in the Dictionary of English above provides the example of the teachers imparting their knowledge to their pupils. Teachers do not impart their knowledge to pupils by way of mere disclosure. They do not simply hand over text books to pupils and expect the pupils to learn the content. The teachers need to actively teach the pupils (i.e. render a service), in conjunction with those text books in order to impart their knowledge to their pupils.

Based on the above, it is safe to say that the term “imparting of know-how”, is not limited to mere disclosure (from an SA perspective) and that, when interpreting any DTA that follows the OECD DTA, even if the commentary to Article 12 is not considered, it is highly unlikely that a SA court would assign such a limited interpretation to the term.

3.5.3. **Application of “imparting of know-how” to show-how**

The final step in the analysis is to compare the term “imparting of know-how” to show-how. The purpose of this analysis is to determine whether show-how includes any services that would not be included in the scope of “imparting of know-how” (and therefore, not included in the royalty definition in terms of Article 12).

3.5.3.1. **Limited services included in show-how**

In the analysis of show-how above it was concluded that the type of services included in show-how is limited to the following:

1) Assistance or services that have the effect of imparting knowledge or information; and

2) Assistance or services, the immediate / dominant purpose of which is the use of the know-how imparted.

As point (1) above will already be included in the OECD DTA definition (by virtue of its inclusion in “imparting of know-how”) it appears that only point (2) is at issue. In other words, what would need to be determined is whether imparting of know-how for the purposes of the OECD would include services, the immediate / dominant purpose of which is the use of the know-how imparted.

3.5.3.2. **Type of services included in know-how**

The above analysis of the term “imparting of know-how” shows that this term specifically includes services with the effect of transferring knowledge. The issue is whether services that do not result in the transfer of knowledge would be included in the imparting of know-how. The Commentary does not provide detailed guidance on this matter, but rather includes examples of services that would not be considered as imparting know-how. Of these examples, the one that could pose the most difficulty is “pure technical services”.

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It is not clear what is meant by “pure technical services”. However, the fact that the commentary recognises that “mixed contracts” (i.e. contracts including imparting of know-how and provision of services) exist could indicate that “pure technical services” as stated in the commentary refers to technical services not forming part of a “mixed contract” (i.e. technical services that are not accompanying know-how being imparted).

In order for the full consideration of a mixed contract to be considered as an amount for imparting know-how, the imparting of know-how needs to be “by far the principle purpose” of that contract. If the imparting of know-how is not the principle purpose of the contract, the consideration would need to be apportioned and given the appropriate tax treatment.

It is not clear whether assistance or services with the immediate or dominant purpose, being the use of the know-how imparted, would be included in Article 12. However, it would appear that amounts for show-how (which would be subject to WHT in terms of section 35) which forms part of a mixed contract will be included in the scope of Article 12 if the principle purpose of that contract is by far the impartation of know-how, regardless of the nature of that service.

Therefore, it is likely that any amounts received in respect of show-how would be included in the scope of know-how if it forms part of a mixed contract, the principal purpose of which is “by far” the imparting of know-how.

3.5.3.3. Issues to consider

There are a few issues that need to be considered. Firstly, it is not certain what is meant by the term “by far the principle purpose” as stated in the commentary. This may imply that the monetary value of the contract needs to be considered. Therefore, if the compensation relating to the use of the know-how is greater than the compensation for the show-how, the use of the know-how would be by far the principle purpose of the contract. However, if the value of the know-how is small relative to the training required, the parties could easily agree to adjust the compensation ratio and assign a higher amount to the know-how to ensure that the entire contract falls within the scope of the Article 12 royalty definition.
Similarly, if the mixed contract involves training requiring a significant period of time, this may give rise to uncertainty as to what would be “by far” the principle purpose of that contact.

Another issue is whether the fact that the know-how imparted and the connected assistance or service are not included in the same contact. The use of the wording “contract” as opposed to “agreement” in the commentary may imply that the full arrangement needs to be reduced to writing at the same time in the same contract. Therefore, any contract entered into for assistance or services after the initial contract for the imparting of know-how has been concluded may not be considered a mixed contract and accordingly, excluded from the scope of Article 12, even though it would likely be included in show-how.

3.6. CONCLUSION

The purpose of this chapter was to determine whether show-how is included in the scope of the royalty definition contained in Article 12 of the OECD DTA.

Know-how can be classified as an intangible capital asset which may be used in its “owner’s” business or it may be let or “imparted” to others for a fee. In this regard, know-how would typically be included in IP licensing agreements. Statistics show that know-how is included in a significant amount of these agreements. It would make sense to include the fee for imparting know-how in the WHT on royalty regime.

Developing nations are more reliant on know-how than their developed counterparts. Furthermore, due to limited technology and investment in developing nations, the assistance on the use of the know-how required would generally be far greater. As SA is a developing nation, the specific inclusion of show-how into the domestic WHT on royalty regime may have been necessary as it would be more likely than not that any know-how imparted would need to be accompanied by show-how.

Included in the SA’s domestic understanding of show-how are services that have the effect of imparting know-how. It is submitted that these types of services will be included in the OECD DTA definition of royalties on the basis that they form part of imparting know-how.
Show-how also includes any assistance or service with a causal connection to the use of know-how. In other words, the immediate or dominant purpose of the service must be for the use of the know-how. The issue is whether these services are included in the scope of the meaning of “imparting know-how”.

The common understanding of imparting know-how, for both SA and the OECD DTA, includes services rendered. Although it is not clear in the OECD DTA as to the type of services included in the term’s scope, the Commentary recognises “mixed contracts”. Any services that have been classified as show-how may form part of imparting know-how if both form part of a “mixed contract” and the imparting of know-how is “by far the principle purpose” of the contract.

It is not certain what the term “by far” would mean in this context. If a high monetary value of the contract can be attached to show-how, or if the show-how involves a significant amount of training or assistance (in time or effort), there is a risk that the show-how may be seen as being “by far” the principal purpose and will therefore be treated differently for treaty purposes.

Another issue is whether show-how, that may clearly relate to know-how imparted, but not included in the same contract, may be treated differently (i.e. not fall within the scope of imparting know-how) on the basis that it does not form part of the same contract (even though the principle purpose of the entire agreement is “by far” for the imparting of know-how).

Although the above “guidelines” should be considered, the classification of show-how as part of imparting know-how appears to be very fact specific and each case would need to be considered based on its own set of facts.

As mentioned in 2.2.2.1, section 35 refers to royalties and similar payments. Accordingly, show-how may be such a “similar payment”. That this taxing section extends its scope beyond the meaning of “royalty” is not of itself problematic. However, for relating such tax to a DTA, it is submitted that a definition of royalty should be inserted into the ITA. Withholding tax levied on such “royalties” would then be subject, in most cases, to Article 12 of the OECD DTA, whereas the withholdings tax on “similar payments” would be subject to another article. Only where “show-how” could be included with the OECD
DTA definition, should it also be included in the ITA definition. This alignment with the OECD DTA is desirable as it creates greater tax certainty.
CHAPTER 4: PROPERTY OR RIGHT OF A SIMILAR NATURE

4.1. INTRODUCTION

The purpose of this chapter is to determine what is meant by the term “property or right of a similar nature” as stated in section 35 of the ITA as this term is not defined therein. The term is not included in the OECD DTA and accordingly, any item falling into the scope of this term will be subject to section 35 but will not be included in the scope of the OECD DTA (and therefore will not be entitled to any relief in terms of Article 12). The purpose of this chapter is to determine what items will be included in the scope of this term.

4.2. WORDING AS USED IN SECTION 35 OF THE ITA

The specific clause is stated here again for further examination and ease of reference:

“the use or right of use in the Republic of, or the grant of permission to use in the Republic

(i) .... property or right of a similar nature; or”

The term “property or right of a similar nature” is preceded by the IP specifically identified in section 35 (i.e. Patents, Trademarks, Copyrights and Designs as defined in their respective acts) and the general IP’s (i.e. model, pattern, plan, formula or process).

The crisp issue is determining what would be included in this term and accordingly, would be subject to section 35. In this regard, there are two schools of thought.

- The term may be given a wide interpretation in that all intangible assets would be included in its scope. This would mean that property not similar to those specifically identified in section 35, such as a mining right, would be included. There appears to be support for this in Juta’s Income Tax67 where the commentary refers to this specific term as being “wide, and covers all other intellectual and immaterial property”.

- The term may be given a more restrictive interpretation. In this regard, the “property or right” which is being referred to should be similar to those

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specifically identified in section 35. It is submitted that it does not cover all immaterial property, as envisaged in *Juta’s Income Tax*.

If it is determined that the term should be given a restrictive interpretation, the next step is to determine what property or rights would be included in its scope.

4.3. **SUBSTANTIALLY SIMILAR TO THE SPECIFICALLY IDENTIFIED PROPERTY**

There appears to be support for the notion that the property or rights should be similar to those specifically identified in section 35.

In *SA Silicone Products (Pty) Ltd*, the court was required to consider whether the taxpayer was correct in claiming an allowance in terms of section 11(gA) on intellectual property which it acquired in a business acquisition. This section grants an allowance for the acquisition of any patent, design, trade mark or copyright or another other property of a similar nature (these IP’s are also included in section 35).

Specifically, the court needed to decide whether the assignment of a trademark licence agreement to the taxpayer amounted to the acquisition of property of a similar nature and therefore included in the scope of section 11(gA). The court found that what the taxpayer acquired was the grant of a temporary right of use of the trademark, as opposed to a proprietary interest therein and accordingly, not property of a similar nature. Although this judgement may have been different for the purposes of section 35 in that this section specifically includes property and rights (and therefore, the temporary right would probably be included in its scope), the court made some useful observations on the common natures of the identified property.

At 139, Heher JJA stated that, in his view, to qualify as property of a similar nature, the property in question “shall possess fundamental characteristics common to those possessed by the specifically identified properties”. He went on further to say that “minor or superficial similarities will not of themselves suffice”.

The above judgement not only supports a restrictive interpretation of the term, it goes further to confirm that, to be of a similar nature, the property in question needs to be more

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68 *CSARS v SA Silicone Products (Pty) Ltd* 66 SATC 131
than merely similar to those specifically identified. It needs to possess the fundamental characteristics common to the specifically identified properties. In other words, the term should be given an extremely restrictive interpretation.

Although the judgement is made in the context of section 11(gA), the wording in section 35 of the term is substantially the same and therefore this specific principle emanating from the SA Silicone case would be equally applicable in the context of section 35.

4.4. COMMON ELEMENTS IN SECTION 35

Now that it has been shown that the “property or rights” need to be similar to those identified in section 35, the next step is to determine the common element/s of the identified property. This is necessary to determine with the other “property or right” is similar (and therefore subject to section 35).

Before determining these common characteristics, it must be mentioned that analysing the identified property individually (i.e. patent, trademark etc.) may not assist in identifying characteristics common to all properties. Each identified property is governed by a separate Act that grants different rights and obligations to the holder of that property. Therefore, the main characteristics of a patent (in terms of the Patent Act) may differ from a trademark (in terms of the Trade Mark Act). It would be more helpful to consider the common element/s for the identified property as used in section 35.

4.4.1. Property that arose from a creative effort

In _ITC 1735_, 69 (which was discussed in detail in chapter 2 above) one of the arguments put forward by the taxpayer (the golf professional) was that the amount that he received from the event organiser for the use of his image, likeliness etc., was consideration for rights which he gave the event organiser and which constituted property or rights of a similar nature to the rights referred to in section 9(1)(b)(i) of the ITA (which is identical to the rights listed in the current section 35 of the ITA). On this basis only 30% of the amount should be taxed in terms of the version of section 35 at that time. At 460, Goldblatt J stated the following:

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69 _ITC 1735_. _supra_. Note 21
“The appellant was paid the monies to allow his name, biographical details and interviews with him to be used in promoting the tournament. Patents, designs, trademarks and copyright are all rights designed to protect the creators or their assigns of original intellectual works. The appellant’s name, likeness, biographical details etc are not creative effort by the appellant and are accordingly of an entirely different nature to the rights listed in s 9(1)(b)(i).”

The court referred to the nature of the property / rights specifically identified in section 35, as opposed to the nature of intangible assets in general, to determine whether the golf professional’s image, likeness etc would constitute property or rights of a similar nature. The fact that the taxpayer received an amount for granting the use of immaterial property (or intangible asset) or which he was the owner was irrelevant. This supports the notion (as discussed above) that the “property or right” referred to in section 35 should not be given its wide or unrestricted meaning.

Furthermore, the court referred to the property listed in section 35 as having one common characteristic. This characteristic is that they are rights designed to protect the intellectual work of their creators. The taxpayer’s image, likeness etc are not creative efforts (i.e. they were not created by the taxpayer) and therefore the “rights” which the taxpayer claimed to have given to the event organiser were of an entirely different nature to those rights listed in section 35.

Accordingly, as the property (i.e. the image, likeness) was not created by the owner, the court concluded that it could not be similar in nature to the specifically identified property in section 35.

4.4.2. **Property derived from a creative mind / intellectual process**

In the *SA Silicone* case, Heher JA stated the following at 139 (while referring to section 11(gA):

> “The common natures of the identified properties, in the sense which I have discussed, embrace their intellectual origins, *ie* their derivation from a creative mind”.

It follows that the common nature, or common element, of the property identified in section 11(gA) (and also in section 35) is that they have been created or derived from a creative mind.
ITC 1772 also dealt with the issue as to whether the section 11(gA) allowance claimed for “property of a similar nature” was correct. The case involved two taxpayers who were granted a licence from the Minister of Transport to construct, operate and maintain a national cellular radio telephony service. The licence fee payable in this regard included an upfront payment of R100 million by the taxpayers. One of the issues brought before the court was whether this initial payment amounted to expenditure for the acquisition of “property of a similar nature” as envisaged in section 11(gA). Similar to SA Silicone’s case, the court found that what was acquired was not property (as is required in section 11(gA)) and accordingly, no allowance may be claimed. As was the case in SA Silicone, the judge commented on what would constitute “property of a similar nature”.

At 215, Van der Merwe J stated the following:

“[...] the ordinary grammatical interpretation of the phrase “property of a similar nature” found in section 11(gA) means 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. The essential requirements therefore are that the taxpayer must pay an amount to a person who has property which he has created or developed by the use of his own intellect [...]”

Consistent with the SA Silicone case, the common element would appear to be that the property must be derived as a result of a creative mind / from the owner’s intellect.

Although section 35 identifies additional property (i.e. model, pattern, plan, formula and process), it is submitted that the inclusion of this additional property will not result in a different common element for the purposes of section 35. On the basis that section 35 includes all the specifically identified properties of section 11g(A), this common element (i.e. property derived from a creative / intellectual process) would equally apply for both provisions.

Furthermore, although the judgement in ITC 1772 also refers to the legal rights of the identified property as being a common element, the additional property identified in section 35 (i.e. model, pattern, plan and process) do not necessarily have to be registered and accordingly, may not enjoy the same legal rights as the identified property in section

70 ITC 1772 (2004) 66 SATC 211
11(gA). Accordingly, this cannot be considered a common element for the purposes of section 35.

4.4.3. **Creative element**

It follows from the above case law that the common element of the identified property is that the property itself must have come into existence via some creative effort. This may seem obvious as the name “Intellectual Property” might indicate such a conclusion. However, as will be explained further on, there are IP’s which may not have been derived from a creative / intellectual process and may not be included in the scope of the term.

4.5. **IP NOT IDENTIFIED IN SECTION 35**

To be considered as “property or rights of a similar nature”, the item in issue needs to possess the fundamental characteristics common to those possessed by the specifically identified properties, being that they must be created by the owner and they must have been created from a creative or intellectual process. For illustrative purposes, two items of IP not specifically identified in section 35 will be considered, namely Plant Breeders Rights and Geographical Indication.

4.5.1. **Plant Breeders Right**

Plant Breeders’ Rights are rights granted to breeders for a new variety of plant. This includes, *inter alia*, the right to plant the exact mix of seed required for the new variety of plant as well as the right to the harvested material.

These rights are distinct from patent rights as it was considered that the latter was inappropriate in dealing with the unique rights required breeders.71 Accordingly, plant breeders’ rights are excluded from the scope of the Patent Act.

In determine whether plant breeders’ rights are subject to section 35, it is necessary to determine whether they would qualify as a “property or right of a similar nature”. From

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the above analysis the question to ask is: does this IP share the creative element required to be considered as being “similar in nature”?

It is submitted that plant breeders’ rights exist to protect an invention from a creative mind. This right is similar to a patent, with the former protecting a biological invention and the latter protecting a mechanical invention. Accordingly, plant breeders’ rights are a “property or right of a similar nature” subject to section 35 (without corresponding relief in Article 12).

4.5.2. Geographical Indication

According to WIPO, a “geographical indication” is “a sign used on goods that have a specific geographical origin and possess qualities or a reputation that are due to the place of origin”. Therefore, agricultural products may have a geographical indication on their packaging such as “Tuscany” for olive oil. Similarly, cutlery may have “made in China” reflected on it. The purpose of this IP is (mainly) to increase the value of the item on which it is reflected.

So again the question is: does this IP share the creative element required to be considered as being “similar in nature”?

It is submitted that this would be highly unlikely. The property being protected (i.e. the place of origin), is not itself a result of a creative effort or an intellectual process. It is merely an indication of where the product originated.

There may be an argument that the mere placement of the place of origin is in itself a creative effort (as this placement may have increased the value of the product). However, this would likely be a minor or superficial similarity as this IP does not possess the fundamental characteristic common to all the specifically identified IP, that being derivation from a creative mind (as discussed in the previous paragraph).

Accordingly, it is submitted that the “geographical indication” IP would not be considered “property or right of a similar nature” in the context of section 35 and accordingly, any

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amounts received in respect of the use of this IP would not be subject to the provisions of section 35.

4.6. CONCLUSION

The purpose of this chapter was to ascertain the scope of the term “property or rights of a similar nature” as used in section 35.

The term may be interpreted as having a wide meaning and accordingly, would include all immaterial property, whether or not they are similar to the specifically identified property. This has received support from some authors. However, the majority of support points to a restrictive interpretation (i.e. the items need to be similar to the specifically identified property).

In terms of SA case law, the property needs to possess the fundamental characteristics common to those possessed by the specifically identified properties in order for it to be of a similar nature. “Minor or superficial similarities” will not be sufficient. Therefore the term should be given an extremely restrictive interpretation.

It is submitted that the characteristic that is common to all the specifically identified property is that those properties are derived from a creative effort. Therefore, if an IP not listed in section 35 was derived from a creative mind (such as a Plant Breeders Right), it would constitute a “property or right of a similar nature” as used in section 35 of the ITA.

As amounts for “property or rights of a similar nature” is not included in the OECD DTA, similar to “show-how”, such amounts may be within the scope of “similar payments” and therefore included in the ambit of section 35. Accordingly, consistent with the issue regarding show-how, the wording of section 35 as a basis for a definition would need to be aligned with the OECD DTA. It may well be that the intention of the legislature is to include “property or rights of a similar nature” within the scope of section 35 of the ITA but not within the definition of royalty (i.e. the amounts defined as a royalty and other amounts are included in the scope of section 35, but only royalty amounts would be treated as such for DTA purposes).
CHAPTER 5: CONCLUSION

The purpose of this dissertation was to ascertain the meaning of the term “royalties” for the purposes of the ITA. The word “royalty” is used throughout the ITA at various points without a corresponding definition.

The first part of the dissertation attempted to formulate an official definition for “royalties” for the purposes of the ITA using the wording already contained in the ITA as well as definitions from other sources. This was discussed in chapter 2.

The remainder of the dissertation (i.e. chapter 3 and chapter 4) considered various aspects of the wording of section 35 (which was used as the basis for the proposed definition in chapter 2). Two aspects were considered, namely:

- the distinction of know-how from services rendered; and

- the meaning of “property or right of a similar nature”.

5.1. DEFINING A ROYALTY

The focus of chapter 2 was the formulation of a definition for the term “royalties” for the purposes of the ITA. The word “royalty” is used throughout the ITA without a corresponding definition. Section 35 provides the most likely meaning of royalties as it lists the items that are subject to a withholding tax on royalties. In addition, wording which is essentially the same as that of section 35, is used throughout the ITA for provisions referring to royalties. Based on the wording in the ITA, the definition would consist of two parts:

(3) amounts received for the use of an IP; and

(4) amounts received for the impartation of knowledge, as well as for services rendered in connection with that knowledge.

The OECD DTA’s definition of royalties is substantially similar to the wording of section 35 in that it also consists of two parts (as above) and that the IPs to which the OECD definition refers are essentially the same.
A common law definition for a royalty was not found to exist for tax purposes. In any event, the common law reviewed has some notable differences to the wording of section 35. Firstly, the common law does not include amounts for imparting know-how. The common law also places great emphasis on the link between the payment and the quantity used, which is not a requirement in section 35. The IP’s covered in section 35 is also limited and does not include IPs such as a mining right (which is likely to be included in the common law definition). Accordingly, based on the current wording in the ITA (i.e. gross income definition dealing with royalties, section 35) the common law would not be appropriate as a basis for a royalty definition for the purposes of the ITA.

It is difficult to ascertain the intention of legislation with regards to the inclusion of the word “royalty” at various points within the ITA. For purposes of section 9D, the subsection currently referring to royalties initially referred to the wording of the deemed source rules for royalties (which is essentially the same as the current wording in section 35). When SA moved from a source-based taxation system to a dual resident and sourced based taxation system, the source provisions were removed from the ITA and the relevant sub-section of section 9D was amended to refer to royalties (without any explanation in the explanatory memorandum as to what the term meant). Even though the source rules were subsequently re-inserted into the ITA, section 9D continued to refer to royalties.

When section 35 was amended to include its current wording, the explanatory memorandum explained that this section relates to “royalties and other similar payments”. Therefore, it is not clear whether it was the intention of Legislature that the wording in section 35 should be used as a meaning for royalties only.

Accordingly, based on the uncertainty above, it is submitted that a definition is required in the ITA and that this definition should follow the wording of section 35. However, this wording should be aligned with the official definition contained in the OECD DTA.

5.2. DISTINGUISHING KNOW-HOW FROM SERVICES RENDERED

In chapter 3, the difference between the wording of section 35 of the ITA and the OECD DTA definition relating to the imparting of know-how was analysed. Section 35 encompasses both the imparting of know-how and show-how whereas the OECD DTA does not specifically include the latter.
Know-how can be classified as an intangible asset capable of being owned and let, or imparted, by the owner.

Show-how is not specifically mentioned in the OECD DTA and therefore it is necessary to ascertain whether it includes any services that are not included in the imparting of know-how (which is included in the OECD DTA).

Show-how includes services that have the effect of transferring knowledge. It is submitted that such services have the effect of imparting know-how and are therefore included in the scope of the OECD DTA.

Show-how also includes services with a “causal connection” to the use of know-how. This means that the immediate or dominant purpose of the service must be for the use of the know-how. This may include services that do not have the effect of transferring knowledge and may not be included in the OECD DTA definition.

The imparting of know-how, for both SA and the OECD DTA, is not limited to mere disclosure and therefore includes services. Although it is not clear in the OECD DTA as to the type of services included in the term’s scope, the Commentary recognises “mixed contracts” (i.e. contracts which include both imparting of know-how and show how). According to the Commentary, services will form part of imparting know-how if they form part of a “mixed contract” and the imparting of know-how is “by far the principle purpose” of the contract.

It is not certain what the term “by far” would mean in this context. If a high monetary value of the contract can be attached to show-how, or if the show-how involves a significant amount of training or assistance (in time or effort), there is a risk that the show-how may be seen as being “by far” the principal purpose and will therefore be treated differently for treaty purposes. Furthermore, if the show-how relating to the know-how imparted is included in separate contract, it may be treated differently on the basis that it does not form part of the same contract (even though the principle purpose of the entire agreement is “by far” for the imparting of know-how).
In conclusion, the classification of show-how as part of imparting know-how appears to be very fact specific and each case would need to be considered based on its own set of facts, using the above findings as guidance.

It may be that show-how is a “similar payment” included in the scope of section 35 but not included in the scope of Article 12 of the OECD DTA. This is not problematic as the “similar payment” may be subject to another article. However, to create greater tax certainty, a definition (aligned with the OECD DTA) should be included in the ITA and the “similar payment” would then be subject to another article (unless it is included in the OECD DTA definition in which case it should be included in the ITA definition).

5.3. PROPERTY OR RIGHTS OF A SIMILAR NATURE

The purpose of chapter 4 was to establish the factors identifying "property or rights of a similar nature" as used in section 35.

Although some authors support a wide meaning (i.e. that the term includes all immaterial property, whether or not they are similar to the specifically identified property) the majority of support points to a restrictive interpretation (i.e. the items need to be similar to the specifically identified property).

In terms of SA case law, the property needs to possess the fundamental characteristics common to those possessed by the specifically identified properties in order for it to be of a similar nature. “Minor or superficial similarities” will not be sufficient. Therefore the term should be given an extremely restrictive interpretation.

It is submitted that the characteristic that is common to all the specifically identified property is that those properties are derived from a creative effort. Therefore, if an IP not listed in section 35 was derived from a creative mind (such as a Plant Breeders Rights), it would constitute a “property or right of a similar nature” as used in section 35 of the ITA. However, this issue is also fact specific and each case would need to be determined on its specific set of facts.

As amounts for “property or rights of a similar nature” is not included in the OECD DTA, they may be within the scope of “similar payments” and therefore included in the ambit of
section 35. Accordingly, the wording of section 35 as a basis for a definition would need to be aligned with the OECD DTA.
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