Evaluation of the "source" rules as contained in section 9 of the South African Income Tax Act as relating to software in the context of the Digital Economy

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by

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ABSTRACT

In recent decades, the rise of the digital economy has drastically changed the way the world does business. Business can now be conducted without regard to geographical boundaries and limitations and organisations have the ability to conduct business making use of mobile and sophisticated software in South Africa without having a significant physical presence in the country. In addition, the characterisation of income from new software-related arrangements may be difficult to determine in this new economy.

In response to the above, there is a general move globally to align taxation with economic substance and value creation and there is an increased focus on source-based taxation.

Consequently, this dissertation conducts an analysis of the relevance and appropriateness of South Africa's source rules pertaining to software arrangements as contained in section 9 of the Income Tax Act (ITA) and as espoused in the common law.

It is submitted that there are four main income characterisations applicable to software arrangements (sales, service arrangements, leases and royalties arrangements) and that it is possible to apportion a software-related payment into these various components for tax purposes. It is only once this characterisation has been completed that the source rules applicable to the various components should be applied. In relation to this, it is submitted that with the exception of show-how as espoused in section 49A of the ITA, the concepts of a royalty and know-how are consistent in the OECD Model Tax Convention and the ITA.

Specifically, in determining if a software payment constitutes a royalty, a distinction should be made between the copyrighted article and the copyright itself, unless the component of the payment attributable to one of the items is clearly insignificant. Only the component of the payment attributable to the use of a copyright would constitute a royalty for South African tax purposes.

In respect of countries with which South Africa has concluded Double Tax Treaties (DTTs), the income categories within which income arising from software arrangements may fall consist broadly of business profits and royalties. In the case of business profit income, the ability of South Africa to tax such income is severely limited by the current concept of a permanent establishment (PE) defined in the OECD Model Tax Convention. The concept of a PE is submitted to be outdated and inappropriate to facilitate the taxation of income arising from software arrangements.

As concerns royalty income accruing to residents of the above countries however, it is submitted that the current source rules in section 9(2) of the ITA are appropriate in that they provide certainty on the source of such income and also enable South Africa to tax income arising in South Africa in line with the benefit and sourcing theories.

In respect of countries with which South Africa does not have DTTs, it is submitted that in respect of sales and service income, the current common law principles applicable are outdated and inappropriate and that it may be necessary to legislate provisions in this regard to provide certainty in the context of the digital economy. In addition, the deemed source provisions in section 9(2) are similarly subject to the same PE limitations noted above.

However, in respect of lease and royalty income accruing to residents of countries noted in the above paragraph, the current source rules contained in the common law and the provisions of section 9(2) remain appropriate to provide certainty on the source of such income and also to enable South Africa to tax this income in line with the benefit and sourcing theories.

Possible solutions to address the above inadequacies broadly comprise the following.

In relation to countries with which South Africa has concluded DTTs:

1) The insertion of a definition for "digital PE" in DTTs with countries who export software services or digital goods to South Africa; or
2) The implementation of a Value-Added Tax (VAT) on the above services or goods rendered by non-resident enterprises in such a manner to encourage the establishment of PEs in South Africa to take advantage of a reduced VAT rate.

It is submitted that both options are possible to implement and would likely achieve the desired outcomes, but it is likely that the implementation of a VAT may be the most effective option given the likelihood that South Africa may not be that successful in renegotiating DTTs with powerful software-exporting countries.

In relation to countries with which South Africa has not concluded DTTs, it is recommended that section 9 of the ITA incorporate definitions for "digital goods and services" and "digital PE" and that the section provide for income arising from such transactions and attributable to such PEs to be deemed to arise from a source in South Africa. These provisions should ideally be incorporated with the recommendations noted relating to countries with which South Africa has concluded DTTs to ensure their effectiveness.

ABBREVIATIONS

BEPS	Base Erosion and Profit-Shifting
DTT	Double Tax Treaty
IP	Intellectual Property
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
RAM	Random-access memory
SARS	South African Revenue Service
The ITA	Income Tax Act, 58 of 1962
UN	United Nations
VAT	Value-Added Tax

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CHAPTER 1: INTRODUCTION

1.1 BACKGROUND

1.1.1 Rise of the digital economy

In recent decades, the rise of the digital economy has drastically changed the way the world does business. Specifically, the digital economy has resulted in the world becoming a "smaller" place in the way that communications from two opposite sides of the world can now happen instantaneously. Business can now be conducted without regard to geographical boundaries and limitations. Increased computing power now allows for certain business activities to be carried out automatically by advanced software. The same business principles of the past still apply in the digital economy, but the manner in which business is now conducted has changed. Inputs still need to be acquired, and value added. Sales still need to be concluded and services still need to be rendered. Payments still need to be effected and processed. Rather, it is the nature of the product sold/service rendered, the manner in which the product is sold or service rendered and the manner in respect of how payment is effected which has changed (OECD, 2014: 127).[1]

The Organisation for Economic Co-operation and Development's (OECD) report on Base Erosion and Profit-shifting (BEPS) deals specifically with the challenges of the digital economy (OECD, 2013: 7-11) and was released in response to the concern of various governments over the erosion of their respective tax bases chiefly as a result of the rise of the digital economy. The digital economy has enabled some corporates to structure their affairs in such a way so as to play various States' tax regimes and treaty networks against one another so as to minimize tax payable. One might argue that it is only natural for every corporate to seek to structure its affairs so as to minimize its tax burden, however there is a growing consensus amongst States that each person should bear their fair share of the tax burden so as to avoid the situation where a person uses the resources provided by a State to generate income and then pays no or limited tax in that State as a result of complex tax manipulation.[2]

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[1] Organisation for Economic and Co-operation and Development [OECD]. 2014. *Addressing the Tax Challenges of the Digital Economy,* OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing. Available: http://dx.doi.org/10.1787/9789264218789-en [2015, April 14].
[2] OECD. 2013. *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing. Available: http://dx.doi.org/10.1787/9789264202719-en [2015, April 14].

It is estimated that the value of total worldwide e-commerce transactions amounted to USD 16 trillion in 2013 (OECD, 2014:17). Although the business principles in the digital economy largely remain unchanged from those of yesteryear, the OECD's BEPS report has identified certain key elements which are relevant for tax purposes. These include (OECD, 2014:84):

1) Mobility with respect to intangibles, users and business functions;
2) Reliance on data;
3) Network effects;
4) The spread of multi-sided business models;
5) Tendency toward monopoly or oligopoly; and
6) Volatility.

Specifically, the importance of intellectual property (IP) in the digital economy in the context of creating value, as well as the mobility of IP, creates significant BEPS opportunities with regard to direct taxation (OECD, 2014:112). The reality is that, in the digital economy, it is possible for significant amounts of income to be generated in a particular jurisdiction without the recipient having a taxable presence there. This raises questions as to whether the current tax source rules remain appropriate in the context of the digital economy (OECD, 2014:128).

Generally, the above creates problems in determining where economic activities are performed and where value is created. Innovative new digital products or means of rendering services also create problems in determining the correct characterisation of income arising from these new products and business models, specifically relating to cloud computing and software arrangements (OECD, 2014:125-126).

The OECD BEPS (2014:146) report has suggested certain action points and proposals, including inserting a new definition of "permanent establishment" based on "significant presence" as well as potentially introducing a withholding tax on the sale of digital goods and services to address the tax risks posed by the digital economy. In general, there is a move to align taxation with economic substance and value creation (OECD, 2014:157). It seems then, that the concept of source-based taxation will be an area of increased importance going forward.

Based on the above, two main concepts emerge which affect direct taxation in the digital economy. These are, the nature of IP and the concept of "source taxation". These are briefly discussed below.

1.1.2 IP and software

IP plays an important role in many businesses. Broadly speaking, IP refers to intangible property arising from creative efforts. Generally, rights to these assets are created which are protected by law (World Intellectual Property Organization [WIPO], 2016).[3]

As intangible products incorporating IP are becoming ever more common and important, together with the fact that much of the developed world is currently operating in a "knowledge-based" economy (Blankley & Booyens, 2010:1), supreme value is placed on information and data important to customers as IP is increasingly used to generate income and improve marketability.[4]

Typical examples of IP include copyrights, patents, designs and trademarks. In relation to South Africa, each of these types of IP are protected by statute.

Specifically, the increased use of software and digital articles has great implications for existing source tax principles. Software has been selected for evaluation on the basis that the crux of the issues pertaining to source taxation in the digital economy appear to relate to the conduct of business in a jurisdiction by an entity without that entity having a significant physical presence therein. Generally, this would only be possible by means of making use of software.

Given the value added by software in generating revenue for businesses, it is necessary to obtain an understanding of the nature of software, the characterisation of income arising from the exploitation of software and, importantly, the source of such income to assess whether South Africa's current income tax legislation is appropriate in ensuring that it receives its fair share of software-related income derived from sources in South Africa.

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[3] World Intellectual Property Organization. 2016. *What is Intellectual Property?* Available: http://www.wipo.int/about-ip/en/ [2016, February 8].
[4] Blankley, W.O. & Booyens I. 2010. Building a knowledge economy in South Africa. *S Afr J Sci.* 106(11/12):1. DOI: 10.4102/sajs.v106i11/12.373

1.1.3 Source-based taxation

Generally, income may be taxed in the jurisdiction where it arises (the source country), or in the jurisdiction where the recipient is resident (the country of residence) (Tax Justice Network, 2005:1).[5] Residence-based taxation is a principle *"according to which residents of a country are subject to tax on their worldwide income and non-residents are only subject to tax on domestic-source income"* (Rogers-Glabush, 2015). [6] The premise of residence-based taxation is that persons should bear a portion of the cost of public services provided in the State in which they reside, no matter where such person's income originates (Tax Justice Network, 2005:1). Source-based taxation is *"a principle for allocating taxing jurisdiction over income according to which a country may tax income having its source in that country, regardless of the residence of the taxpayer"* (Rogers-Glabush, 2015). It is premised on the principle that the State which affords income-generating opportunities should be compensated in the form of being awarded taxing rights to the associated income (Pinto, 2003:18).[7]

In order to address the situation where one country taxes an amount of income due to the fact that the person receiving it is resident in that country, whilst another country also taxes that income by virtue of its source being in that other country, the League of Nations, and later the United Nations (UN) and the OECD, developed a range of model treaties to avoid the instance of "double-taxation" (Vogel, 2005:11).[8]

Essentially the treaties endeavour to obtain a compromise between source and residence taxation, whereby the source country is usually given taxing rights to active business income for activities occurring in its jurisdiction, whilst in respect of passive income, taxing rights are tilted in favour of the country in which the taxpayer is resident (Tax Justice Network, 2005:2).

It is interesting to note that capital-exporting developed countries tend to favour the OECD model convention, which favours residence-based taxation, while poorer capital-importing

[5] Tax Justice Network. 2005. *Source and Residence Taxation. September: 1-4*. Available: http://www.taxjustice.net/cms/upload/pdf/Source_and_residence_taxation_-_SEP-2005.pdf [2015, April 28]
[6] Rogers-Glabush, J. 2015. 7th rev. ed. *IBFD International Tax Glossary*. Amsterdam: IBFD. Available: IBFD's Tax Research Platform [2016, January 19].
[7] Pinto, D. 2003. *E-Commerce and Source-Based Income Taxation.* Amsterdam, the Netherlands: IBFD Publications BV.
[8] Vogel, K. 1986. Double Tax Treaties and Their Interpretation. *Berkeley Journal of International Law*. 4(1):11.

countries prefer the UN model convention, which is favourable to source-based taxation (Daurer & Krever, 2014:1-2).[9]

If a pure residence-based taxation were implemented globally, the revenue of poorer capital-importing countries would decrease as most investors reside in wealthier countries. The converse would also be true if a pure source-based taxation regime were implemented globally (Tax Justice Network, 2005:2-3).

Consequently, it seems as though a compromise between residence-based and source-based taxation will remain in the global context given the current conflicting interests of various States noted above. Given the increasing importance of the developing world in driving economic growth, it seems that a global taxation regime which gives preference to source-based taxation, but also retains elements of residence-based taxation will be favoured in the future (Tax Justice Network, 2005:3).

This is in accordance with the OECD BEPS report which seeks to align the taxation of income with economic activities and value creation (OECD, 2014:157).

South Africa implements a residence-based taxation regime, but taxes non-residents on a source basis. There is no definition of the term "source" in the Income Tax Act[10] (the ITA), however there is a significant body of case law setting out principles for determining the source of an item of income, although such case law is subject to the provisions of section 9. Section 9 of the ITA provides rules for determining when an item of income is deemed to be from a source within South Africa.

Given the concerns noted in the above paragraphs regarding the digital economy and the ability of organisations to conduct business making use of mobile and sophisticated software in South Africa without having a significant physical presence in the country[11], together with the fact

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[9] Daurer, V. & Krever, R. 2014. Choosing between the UN and OECD Tax Policy Models: An African Case Study. *African Journal of International and Comparative Law.* 22(1): 1-10. (WU International Taxation Research Paper Series No. 2014 - 16).

[10] Income Tax Act, No. 58 of 1962, as amended. 2014. Available: http://www.mylexisnexis.co.za/Index.aspx [2016, January 26].

[11] The OECD BEPS report (2014:129) specifically notes that: *"Although it is true that tax treaties do not permit the taxation of business profits of a non-resident enterprise in the absence of a PE to which these profits are attributable, the issue of nexus goes beyond questions of PE under tax treaties. In fact, even in the absence of the limitations imposed by tax treaties, it appears that many jurisdictions would not in any case consider this nexus to exist under their domestic laws. For example, many jurisdictions would not tax income derived by a non-resident enterprise from remote sales to customers located in that jurisdiction unless the enterprise maintained some degree of physical presence in that jurisdiction. As a result, the issue of nexus also relates to the domestic rules for the taxation of non- resident enterprises."*

that the characterisation of income from software-related arrangements may be difficult to determine, it is important to identify whether the current source rules implemented by South Africa remain appropriate.

An analysis of the relevance and appropriateness of South Africa's source rules pertaining to software, as contained in section 9 of the ITA and as espoused in the common law, will constitute the main thrust of this dissertation.

1.2 RESEARCH PROBLEM

1.2.1 Inadequacy of source rules contained in section 9 of the ITA in relation to software-related income in the context of the digital economy

As alluded to in the previous paragraphs, the specific source rules contained in section 9 of the ITA may not be sufficient to ensure software-related income associated with the use of software, which arguably should be taxed in South Africa, is in fact taxed in South Africa.

This is specifically relevant in relation to new types of software which allow organisations to interact and conduct business in South Africa without having a significant physical presence in the country.

Specifically, the relevant paragraphs of section 9(2) are set out below which state when certain items of income are deemed to arise from a source within South Africa in relation to IP:

> *"An amount is received by or accrues to a person from a source within the Republic if that amount—...*
>
> *c) constitutes a royalty that is attributable to an amount incurred by a person that is a resident, unless that royalty is attributable to a permanent establishment which is situated outside the Republic;*
>
> *d) constitutes a royalty that is received or accrues in respect of the use or right of use of or permission to use in the Republic any intellectual property as defined in section 23I;*
>
> *e) is attributable to an amount incurred by a person that is a resident and is received or accrues in respect of the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information, unless the amount so received or accrued is attributable to a permanent establishment which is situated outside the Republic;*

f) is received or accrues in respect of 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;

k) constitutes an amount received or accrued in respect of the disposal of an asset other than an asset contemplated in paragraph (j) if—

ii) that person is not a resident and that asset is attributable to a permanent establishment of that person which is situated in the Republic; or…"

Section 9(4) further provides what is deemed to be from a source outside South Africa:

"An amount is received by or accrues to a person from a source outside the Republic if that amount—

c) constitutes a royalty received by or accrued to that person that is not from a source within the Republic in terms of subsection (2) (c) or (d);

d) constitutes an amount received or accrued to that person in respect of the disposal of an asset that is not from a source within the Republic in terms of subsection (2) (j) or (k);…"

A royalty is defined in section 9(1) for the purposes of section 9 as *"any amount that is received or accrues in respect of the use, right of use or permission to use any intellectual property as defined in section 23I."*

This brings out the first issue to be identified in respect of the potential inadequacy of the source rules contained in section 9. The application of the rules in section 9(2)(c) and (d) is somewhat limited to income constituting "royalties" and by implication only applies to IP as defined in section 23I. Are the definitions pertaining to a "royalty" and "intellectual property" as contained in the ITA broad enough to ensure all income attributable to software employed in the digital economy in South Africa is taxed in South Africa?

Secondly, the question arises in respect of section 9(2)(d), as to what is actually intended by the phrase: *"the use or right of use of or permission to use in the Republic"*.

Thirdly, questions arise in respect of the scope and application of sections 9(2)(e) and (f) in relation to software arrangements not qualifying as IP in terms of section 23I. Would these provisions cover software arrangements not addressed by the definition of IP or is their application only limited to so-called "know-how" and "show-how".

Lastly, a question arises with regard to section 9(2)(k) which specifically pertains to e-commerce. Based on the current wording of the section, income from the sale of movable assets would only be deemed to be from a source in South Africa where the amount has accrued to a non-resident and where the asset is attributable to a permanent establishment (PE) of the non-resident in South Africa. Consequently, the question must be asked whether the definition of a PE in South Africa should be amended so as to ensure income arising from e-commerce conducted by non-residents having customers in South Africa is taxed in South Africa.

1.2.2 Common law principles may be outdated in respect of their application to the digital economy, specifically relating to new forms of digital products and IP

There is a wealth of South African and international case law concerning the source of certain items of income for tax purposes. Many of these cases date from before the rise of the digital economy, and therefore, the decisions reached in many of them may no longer be relevant. Given this, there is an even greater need to obtain certainty in respect of the source of income in the digital economy and whether this should be legislated to avoid reliance on the outdated decisions of the courts.

1.2.3 If new source rules should be introduced in respect of the digital economy, how would this be practically implemented and would South Africa's treaty network be affected?

If adjustments are made to the source rules contained in section 9 of the ITA, the practicalities of collecting taxes concerning income accruing to persons with no or limited physical presence in the country would have to be considered. If income accruing to these persons were subject to tax in South Africa, would these persons have to register separately for income tax in South Africa or would it be more practical to implement a withholding tax on payments exiting the country?

Consideration must also be given to South Africa's treaty network and whether any potential adjustment to the section 9 source rules will be effective in allowing South Africa to tax software-related income given the royalty and business profits articles in the existing treaty network.

1.3 LIMITATION OF SCOPE

The scope of this dissertation is limited to the evaluation of the current source rules contained in section 9 of the ITA as amended up until the Taxation Laws Amendment Act of 2014[12], and will exclusively focus on sections 9(2)(c), (d), (e), (f) and (k).

An evaluation of the most prominent case law relevant to software and copyright in relation to source-based taxation will also be performed. In performing this evaluation, only South African case law will be analysed, however international case law will be considered in determining if the principles established in these South African cases still prove to be relevant. In this regard, only the most prominent international tax cases with regard to the taxation of software-related income in the digital economy will be considered.

The evaluation of the current source rules noted above will be evaluated by means of analysing the current main income characterisations applicable to software arrangements and applying the conclusions from this analysis to the current source rules to determine if arrangements incorporating these various income characterisations would escape taxation in South Africa.

Based on the above evaluation, a conclusion will be reached concerning whether the current source rules as contained in sections 9(2)(c), (d), (e), (f) and (k) should be amended to ensure that income arising from these arrangements is caught within the South African tax net.

1.4 STRUCTURE OF DISSERTATION

Chapter 2 of this dissertation will consider the meaning of software, digital content and copyright in the South African context, specifically in relation to IP defined in section 23I of the ITA. The concept of copyright and its relation to software for tax purposes will be analysed for the purposes of providing a framework against which to assess the source rules contained in section 9 of the ITA.

Chapter 3 will set out an analysis of the characterisation of income applicable to various software arrangements with the objective of providing a foundation which can be used to evaluate the source rules applicable to each characterisation.

Chapter 4 will set out the current legislative and common law principles applicable to source taxation in South Africa in relation to software arrangements, and an evaluation of these principles will be performed using the conclusions reached in chapters 3 and 4.

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[12] No. 43 of 2014

Chapter 5 will include a discussion on possible proposals to address any inadequacies identified in chapter 4.

1.5 RESEARCH METHODOLOGY AND METHODS

1.5.1 Research Methodology

This dissertation seeks to determine whether the source rules as contained in section 9 of the ITA are still appropriate in respect of software arrangements in the context of the digital economy, including whether the enactment of legislative adjustments may be necessary. In evaluating the above, a qualitative research approach will be followed wherein a doctrinal research methodology will be adopted.

Doctrinal research methodology comprises the identification, analysis and conclusions relating to current legislation (McKerchar, 2008:15).[13]

Consequently, as the dissertation will evaluate legislative provisions, the principles of interpreting fiscal legislation as applicable in South Africa will also be applied. In interpreting fiscal legislative provisions, South African courts apply common law principles of interpretation.

The interpretation of fiscal statutes has evolved over the years, with the current position being summarised in the case of the *Natal Joint Municipal Pension Fund v Endumeni Municipality*[14] (the so-called *Natal Pension Fund* case). This case summarises the approach whereby the courts will give effect to an interpretation of a statute that reflects the intention of the legislature. In determining the intention of the legislature with respect to a particular provision, a literal interpretation of statute is favoured by the courts, but not in isolation. The intention should also be determined by taking into account the apparent purpose of the provision, the context in which it appears, and the material available to the drafters of the provision.[15]Only

[13] McKerchar, M. 2008. Philosophical Paradigms, Inquiry Strategies and Knowledge Claims: Applying the Principles of Research Design and Conduct to Taxation. *eJournal of Tax Research.* 6(1): 15.

[14](2012) (4) SA 593 (SCA)

[15] Judge Wallis notes at paragraph 18: *"The present state of the law can be expressed as follows. Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence. Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production. Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document."*

where a literal interpretation would lead to an *"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 into taking into account…"* (See *Rex v Venter* (1907) TS 910 at 915), will the court depart from such literal interpretation.

However, where a provision is merely ambiguous as to its meaning, the courts have often applied the so-called *contra fiscum*[16] rule with regard to fiscal legislation whereby an interpretation in favour of the taxpayer is favoured in instances where a provision may be reasonably interpreted in more than one way. In *Commissioner for Inland Revenue v Widan*[17] the court found that the *contra fiscum* rule only applied where the intention of the legislature was not clear. It is not clear if this approach is still applicable after the *Natal Pension Fund* case (supra), but it is submitted that until clarity is obtained on the matter it should still be regarded as being in operation (Steyn, 2013).

1.5.2 Research Methods

Specifically, data will be collected by means of performing a literature review. Thereafter case studies will be used to evaluate the legislation by identifying certain scenarios and applying current legislation and case law to the particular scenario to determine the adequacy of the existing legislative provisions.

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[16] Steyn, M.T. 2013. Interpretation of fiscal legislation. University of Cape Town [Lecture]. January, 9.
[17] (1955) 19 SATC 341

CHAPTER 2: ANALYSIS OF THE NATURE OF SOFTWARE, DIGITAL CONTENT AND COPYRIGHT

2.1 INTRODUCTION

As discussed in the previous chapter, software and digital content have become a major part of commerce in the modern world, whether constituting the final product or service consumed by customers or being used as tools to deliver products or render services.

This chapter aims to elaborate on the nature of software, as distinguished from digital content, and its connection with IP with the aim of identifying current issues pertaining to the taxation of income associated with software to provide a framework against which current business arrangements incorporating software can be assessed.

2.2 SOFTWARE AND DIGITAL CONTENT

The term "software" is not defined in the ITA. Consequently, it is necessary to consider the ordinary meaning of the word to glean an understanding of what exactly it comprises.

The Oxford English Dictionary[18] defines software as *"the programs and other operating information used by a computer."*

The term "program" is defined in the Oxford English Dictionary ("program, n.", 2010) as *"a series of coded software instructions to control the operation of a computer or other machine."*

From a tax perspective, the 2014 OECD commentary to article 12 provides further guidance and describes software as "*a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software)."*[19]

It also makes reference to the fact that software can be transferred through various media, can be standardised or customised and that it can be transferred as part of computer hardware or independently of such hardware (paragraph 12.1 of the 2014 OECD commentary to article 12).

From the above, it is clear that software is essentially any set of instructions to be processed by a computer.

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[18] Stevenson, A. Ed. 2010. *Oxford Dictionary of English.* 3rd ed. rev. USA: Oxford University Press.
[19] Paragraph 12.1 of the 2014 OECD commentary to article 12.

Digital content on the other hand, is much wider and includes any product (including software) which can be expressed in a digital form i.e. *"being expressed as a series of the digits 0 and 1"* according to the Oxford English Dictionary ("digital, adj.", 2010). The 2014 OECD commentary to article 12, in paragraph 17.2, categorises digital products into four categories being software, images, sounds or text.

As this dissertation is primarily concerned with the tax issues pertaining to software in the digital economy, the concerns relating to digital content other than software will not be considered further.

2.3 SOFTWARE AND COPYRIGHT

As will be discussed later in this dissertation, there are many different forms of business arrangements in which software is employed in the digital economy. Each form of business arrangement may be characterised differently for tax purposes giving rise to different tax implications. The characterisation of income pertaining to software in the digital economy is evaluated in chapter 3, but in this chapter the connection between software and copyright will be evaluated as to its relevance in determining whether a payment for the use of software constitutes a royalty for the purposes of the ITA.

For South African tax purposes, a royalty is defined in section 9(1) of the ITA for the purposes of section 9 as *"any amount that is received or accrues in respect of the use, right of use or permission to use any intellectual property as defined in section 23I."*

Section 23I of the ITA defines "intellectual property" as meaning any:

"

a) patent as defined in the Patents Act including any application for a patent in terms of that Act;

b) design as defined in the Designs Act;

c) trade mark as defined in the Trade Marks Act;

d) copyright as defined in the Copyright Act;

e) patent, design, trade mark or copyright defined or described in any similar law to that in paragraph (a), (b), (c) or (d) of a country other than the Republic;

f) *property or right of a similar nature to that in paragraph (a), (b), (c), (d) or (e); and*

g) *knowledge connected to the use of such patent, design, trade mark, copyright, property or right;"*

As can be seen from the above, software is not an item of IP listed in the definition of IP in section 23I of the ITA. Similarly, it is not specifically mentioned in the royalty definition in article 12 of the 2014 OECD Model Tax Convention on Income and on Capital[20] (OECD Model Tax Convention). However, research by the OECD indicates that only one of the OECD member countries does not protect software under copyright law.[21] Similarly, South Africa has adopted the view that copyright is the best division of law providing protection for software against copying and other forms of exploitation (Dean, 1995:86).[22]

This is also shown by the fact that the alternative form of protecting software, being patent law, was not pursued by South Africa as evidenced by section 25(2) of the Patents Act[23]which specifically provides that computer programs are not proper subject matter for registration as a patent (Dean, 1995: 86).

Although copyright and software are two different concepts, it is inherent in the nature of software that in order for software to be used, it needs to be copied onto or within a computer. Thus, ordinarily, whenever software is used which is subject to copyright, that copyright will also in fact be used.

Consequently, it is clear that usually at least a portion of an amount that is received or accrued in respect of the use or right of use of software should constitute a royalty for South African tax purposes if the software is subject to a copyright as defined in the Copyright Act.[24]

This brings us to the question of what constitutes a copyright in terms of the Copyright Act, which is discussed below.

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[20] OECD. 2015. *Model Tax Convention on Income and on Capital 2014*. Paris: OECD Publishing.
[21] Paragraph 12.2 of the 2014 OECD commentary to article 12.
[22] Dean, O.H. 1995. Protection of computer programs by copyright in South Africa. *Stellenbosch Law review.* 6 (1): 86-96.
[23] Patents Act, No. 57 of 1978, as amended. 2008. Available: http://www.mylexisnexis.co.za/Index.aspx [2016, January 26].
[24] Copyright Act, No. 98 of 1978, as amended. 2008. Available: http://www.mylexisnexis.co.za/Index.aspx [2016, January 26].

2.4 COPYRIGHT

2.4.1 Introduction

Copyright is important in the context of the digital economy in that the digitisation of products and information has made it very easy to reproduce products which would not have been the case prior to the emergence of the electronic age.

Without protection in the form of copyright, authors of creative and intellectual works would not be able to sustain an economic existence as their source of income would be destroyed or significantly impaired by imitators seeking to derive income from the same copied works.

2.4.2 Nature of copyright in terms of South African domestic law

Copyright has been said to constitute *"the exclusive right in relation to a work embodying intellectual property (i.e. the product of the intellect) to do or to authorise others to do certain acts in relation to that work, which acts represent in the case of each type of work the manners in which that work can be exploited for personal gain or profit"* (Dean, 1987:2).[25]

Copyright is protected in South Africa in terms of the Copyright Act. The Copyright Act extends protection against copying and other forms of exploitation for various listed works eligible for copyright. Eligible works qualifying for copyright protection include, *inter alia*, literary works, musical works, artistic works, cinematograph films, sound recordings, broadcasts, programme-carrying signals, published editions and **computer programs**.[26]

The term "computer program" is defined in the Copyright Act as *"a set of instructions fixed or stored in any manner and which, when used directly or indirectly in a computer, directs its operation to bring about a result"*.[27] This definition clearly includes the concept of software as discussed in 2.2 above.

It is important to note that registration of a work is not necessary for the work to enjoy copyright protection as copyright comes into being automatically at the time it is created, subject to certain requirements being met (Dean, 1995: 88).

The first requirement is that the work must be "original". The Copyright Act contains no definition of the term "original", but in terms of the common law, the courts have held that

[25] Dean, O.H. 1987. *Handbook of South African copyright law.* Cape Town, South Africa: Juta.
[26] Section 2 of the Copyright Act.
[27] Section 1 of the Copyright Act.

originality refers to *"original skill or labour in execution, not to original thought or expression of thought"*. The expression need not be novel, but *"the work must emanate from the author himself and not be copied from another work"*. As to the degree of labour or skill which is regarded as being sufficient to give rise to an original work, it must be shown that at least *"some labour, skill or judgement"* was expended on the work. This will be the case where the work is a substantial improvement on that which preceded it.[28]

The second requirement is that the work must be reduced to a material form.[29]The last requirement is that either:

1) The author of the work must be a "qualified person"[30] at the time of the creation of the work. A qualified person, in the case of an individual, is a South African citizen or someone domiciled or resident in South Africa, and in the case of a juristic person, a person which is incorporated in South Africa; or

2) The work must be published first in South Africa or made in South Africa.[31]

As South Africa has signed the Berne Convention[32], which is an international agreement relating to copyright protection, the Copyright Act has been extended in its application to nationals or residents of other countries party to the Berne Convention. Consequently, any reference to South Africa in the above requirements should also be read as referring to a Berne Convention country.[33]

South Africa's adherence to the Berne Convention means that foreign works (of countries party to the Berne Convention) enjoy copyright protection in terms of South African law, and South African works enjoy copyright protection overseas (in Berne Convention countries) (Dean, 1995:89).

Generally, the Copyright Act provides that ownership of copyright vests in the author. The term "author" is defined in the Copyright Act in relation to each category of work. In respect of computer programs, it refers to the person who *"exercised control over the making of the*

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[28] *Kalamazoo Division (Pty) Limited v Gay and others* (1978) (2) SA 184 (C) at 190 A-D; *Haupt v Brewers Marketing Intelligence (Pty) Ltd* (2004) 908 JOC (A); *Topka v Ehrenberg Engineering (Pty) Ltd* (1983) 71 JOC (A).

[29] Section 2(2) of the Copyright Act.

[30] Section 3(1) of the Copyright Act.

[31] Section 4(1) of the Copyright Act.

[32] *Berne Convention for the Protection of Literary and Artistic Works.* 1979, opened for signature 28 September 1979, entered into force 19 November 1984.

[33] Section 3(1) read with section 37 of the Copyright Act and notice Government Notice no. 136 of 1989-03-03.

computer program."[34] Notable exceptions in the case of software include where the software is developed in the course of the author's employment, in which case the ownership vests in the employer[35], and in the case where the program is created under the control or direction of the State, in which case ownership vests in the State.[36]

Although ownership vests in the author, it is transferable by written assignment, testamentary disposition or operation of law.[37] Once copyright subsists in a work it lasts for a period of 50 years, in the case of computer programs, from the end of the year in which the work is made available to the public with the consent of the copyright owner, or in the event that does not happen within 50 years of the making of the work, 50 years from the end of the year in which the work is made.[38]

The nature of copyright has been briefly described in relation to computer programs in South Africa. It is now necessary to determine what would constitute the "use" of a copyright for South African tax law purposes as alluded to in 2.3 above.

2.4.3 Meaning of "use of copyright" for South African tax purposes in relation to software

The Copyright Act defines the term "copyright" as meaning a copyright under the Copyright Act. In *ITC 1735*[39] (the facts of which are discussed later in this dissertation), the court had to consider the legal position of copyright in South Africa. Judge Goldblatt indicates at 12.4 that copyright subsists only by virtue of statute, namely the Copyright Act.[40] This case clearly indicates that the meaning of copyright in the context of the ITA should be derived solely from

[34] Section 1 of the Copyright Act.
[35] Section 21(d) of the Copyright Act.
[36] Section 21(2) read with section 5 of the Copyright Act.
[37] Section 22(1) of the Copyright Act.
[38] Section 3(2)(b) of the Copyright Act.
[39] (2002) 64 SATC 455
[40] Judge Goldblatt notes at 12.4: *"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.' The 1978 Act does not contain any comprehensive definition of the term 'copyright' but merely states that copyright means copyright under the Act. An examination of the Act reveals that copyright is something which vests the exclusive right to do or authorise the doing of certain acts listed in those sections of the Act relating to specific types of copyright. Even so, in general terms, copyright might be described as that right which vests in a qualified author of an original work recognised by the Act (or a person having acquired rights from or through him) and which enables him to prevent unauthorised copying of that work."*

its intended meaning as governed by the provisions of the Copyright Act and not by reference to the general meaning of the word.

Although the Copyright Act does not contain a comprehensive definition of the term "copyright", its nature is described in relation to each eligible work. Specifically in terms of computer programs, section 11B of the Copyright Act states that *"Copyright in a computer program vests the **exclusive right** to do or authorise the doing of any of the following acts in the Republic…".*[41]

From the above, it is clear that a copyright, in relation to computer programs, constitutes an exclusive right to perform or authorise the performance of certain acts.

The Copyright Act contains certain exceptions where the reproduction of a work is deemed not to constitute an infringement of the copyright. Specifically in relation to computer programs, section 19B of the Copyright Act provides that a copyright in a computer program shall not be infringed by:

> *"a person who is in lawful possession of that computer program, or an authorised copy thereof, if:*
>
> 1) *he makes copies thereof to the extent reasonably necessary for back-up purposes;*
> 2) *a copy so made is intended exclusively for personal or private purposes; and*
> 3) *such copy is destroyed when the possession of the computer program in question, or authorised copy thereof, ceases to be lawful."*

It is submitted that to the extent an act which is listed in section 11B falls within the ambit of section 19B, such an act would not constitute the use of a copyright, as such a right is an exclusive right (in accordance with section 11B of the Copyright Act) vesting in the author and

[41]The specific acts referred to in section 11B include:
"(a) Reproducing the computer program in any manner or form;
(b) publishing the computer program if it was hitherto unpublished;
(c) performing the computer program in public;
(d) broadcasting the computer program;
(e) causing the computer program to be transmitted in a diffusion service, unless such service transmits a lawful broadcast, including the computer program, and is operated by the original broadcaster;
(f) making an adaptation of the computer program;
(g) doing, in relation to an adaptation of the computer program, any of the acts specified in relation to the computer program in paragraphs (a) to (e) inclusive;
(h) letting, or offering or exposing for hire by way of trade, directly or indirectly, a copy of the computer program."

to the extent an act does not infringe upon that exclusive right, it cannot be said that the exclusive right was used by another person.

Consequently, it is submitted that a copyright vesting in a computer program can only be used by a person to the extent that the act performed by the person would otherwise constitute an infringement of the copyright without authorisation from the author.

The question that flows from the above is the determination of what acts could conceivably fall within the ambit of section 19B of the Copyright Act.

2.4.4 Acts falling within the ambit of section 19B of the Copyright Act

No case law exists regarding the application of section 19B. However, literature suggests that section 19B was inserted in the Copyright Act as a practical concession[42] with regard to software used for private purposes given the fact that copyright will almost always be infringed in such cases, as it is inherent in software that copies would have to be made on a computer to facilitate the effective functioning thereof.

Given the dearth of case law on the section, it is necessary to consider the wording of the section and the ordinary plain meaning of the words that appear in the provision, particularly the phrases "back-up purposes" and "personal or private purposes".

It is clear that for an act to fall within the ambit of section 19B, the copy must be made for back-up purposes. The Oxford English Dictionary defines a back-up as *"a copy of a file or other item of data made in the case the original is lost or damaged" (*"back-up, n.", 2010). It seems that the purpose of a back-up is to restore data should the original copy be damaged or lost. Without this purpose, a copy of an article is not a back-up, but merely a copy.

In the context of software, copies are made by virtue of the software operating on a computer (i.e. by means of copying the program between the hard disk and random-access memory (RAM) etc., or by means of copying onto the hard drive temporarily from a location over the internet) to facilitate the operation of the software on the computer. It can be argued that such copies made within the computer are made for back-up purposes as without the copies being made to RAM or the hard disk, the computer would not be able to process the program as data would be lost or damaged continually in transmission.

[42] Copeling, A.J.C. 2003. Copyright. In *Law of South Africa.* 5(2): 43. Available: http://www.mylexisnexis.co.za/Index.aspx [2015, July 14].

On the other hand, it may be argued that such copies are not made to prevent the loss or damage to data, but are made to facilitate the effective operation of the program.

In light of the apparent purpose of the provision, being a practical concession, it is submitted that such copies made within a computer to facilitate the effective operation of a program would fall within the meaning of the word “back-up”.

It is necessary to also consider the meaning of the phrase “personal or private”. The Oxford English Dictionary defines the term “personal” (“personal, adj.”, 2010) as meaning *“belonging to or affecting a particular person rather than anyone else”* or alternatively, *“of or concerning one’s private life, relationships, and emotions rather than one’s career or public life”*. The term “private” is defined in the Oxford English Dictionary (“private, adj.”, 2010) as meaning *“belonging to or for the use of one particular person or group of people only”* or in the context of an activity, *“involving only a particular person or group, and often dealing with matters that are not to be disclosed to others”*. It is clear that section 19B refers to the purposes of certain acts, and in this regard, cognisance must be taken of the fact that a group of persons may have a private purpose as alluded to in the above definition. Consequently, it is submitted that a company, being a group of persons, or even a separate juristic person in its own right may have a private purpose.

It is submitted that in light of the intention of section 19B being a practical concession for making copies, such a concession would not make sense if it were limited to natural persons. It is submitted that to the extent an organisation makes copies of software for use only within a defined group of people and in line with the intended use of the software, that use would constitute private or personal use as contemplated in section 19B.

In conclusion, to the extent that copies of software are made within a computer to merely facilitate the operation thereof, whether by a natural person or a juristic person, it is submitted that such an act would fall within the ambit of section 19B.

2.4.5 Limited licence granted by software developers

The issue of copyright infringement in the case of copies made within a computer is usually avoided by means of a software seller granting the purchaser thereof a limited licence to use the copyright subsisting in the software to facilitate the effective operation of the software. Although it has been argued above that such use would likely not constitute the use of a copyright in any event, this approach avoids legal uncertainty.

The tax consequences pertaining to arrangements where limited licences are granted to purchasers of software will be dealt with later in this dissertation.

2.5 CONCLUSION

Software, digital content and copyright are all inter-related. It is vital to understand the interaction between software and copyright in order to determine the true nature of payments made in respect of various business arrangements incorporating software.

Although copyright usually subsists in software and it will usually be the case that the use of software will result in the use of a copyright given the inherent nature of the operation of software, this is not always the case. In terms of South African copyright law it can be argued that copies made of a computer program to facilitate the effective operation thereof do not constitute the use of a copyright. Payments made in such arrangements would arguably not be made for the use of a copyright and thus would not constitute royalties for the purposes of the ITA.

CHAPTER 3: THE CHARACTERISATION OF INCOME ASSOCIATED WITH SOFTWARE

3.1 INTRODUCTION

According to Westin (2013:216)[43], any e-commerce payment can fall into at least one of the following categories:

> *"1) A lease of space or use of a computer, server or similar equipment;*
>
> *2) A royalty for the use of a copyright or other intangible;*
>
> *3) Business profits of the payee;*
>
> *4) A payment for services rendered to the customer;*
>
> *5) A purchase of tangible or intangible goods; or*
>
> *6) Some combination of the above."*

Based on the above, the character of income pertaining to software and digital content can take many forms, but essentially all income related to e-commerce can be broadly classified into one or more of three main categories: compensation for the transfer of property, the lease of property or compensation for the rendering of services. Support for this broad classification split can be found in one of the leading tax cases regarding the source of income in South Africa, being the *Lever Brothers* case[44], where Judge Schreiner noted at page 16:

> *"With a few possible exceptions (one thinks of the coiner and the bank-note forger, who may be said, literally, to make their money, and the primary producer in so far as he produces for his own consumption what is treated as income) the taxpayer obtains his income from other persons(a) because he renders them services, or(b) because they have the use of his property, or(c) because he carries on in the world of commerce and industry profit-producing activities involving in various combinations the transfer of the ownership in property or the grant of its use or the rendering of services."*

The crucial enquiries which should be made in determining the correct classification of income received are identifying what the customer actually receives from the transaction as well as determining the key driver of value in the arrangement. Once the value drivers of the

[43]Westin, R. 2000. *International Taxation of Electronic Commerce*. The Hague, the Netherlands: Kluwer Law International.
[44] *CIR v Lever Brothers & Unilever Ltd* (1946) 14 SATC 1

transaction are identified, the transaction may be characterised into its income components for tax purposes.

In relation to the lease of property, the nature of the income may be further subdivided into the categories of rental income and royalty income (being a form of rental for the use or right to use IP).

Many business arrangements may actually combine a number of the above characterisations in one business transaction. Each characterisation has specific, and in some cases, vastly different tax consequences.

Consequently, one of the biggest discussion points regarding the taxation of income attributable to e-commerce, and by implication software and digital content, is the characterisation of income flowing from certain business arrangements.

This leads to the first important point to analyse regarding the characterisation of income flowing from software arrangements, namely the distinction between the sale of property, sale of services and leases.

3.2 GENERAL LEGAL ANALYSIS OF THE DIFFERENTIATION BETWEEN THE SALE OF PROPERTY, SERVICES AND LEASING ARRANGMENTS IN SOUTH AFRICA

The distinction between the sale of property, the sale of services and leases is important from an income tax perspective as the source rules pertaining to each type of income differ in South Africa.

The terms "sale", "lease" and "services" are not defined in the ITA and consequently, it is necessary to ascertain their meaning for South African tax purposes in terms of the common law.

3.2.1 Contract of sale and service arrangements

According to some, the basic distinction between the sale of a product and a service arrangement is whether the customer acquires property from the provider. It is inherent in service arrangements that the customer does not derive value from the transaction in the form of a clearly identifiable property interest. In cases where property is given to the customer as an incidental part of the services rendered, the transaction should nonetheless be wholly characterised as a service transaction (Westin, 2000:217).

This is in accordance with the South African common law position where a contract of sale has been referred to as a contract in which one person (the seller) agrees to deliver property to another person and, in exchange, that other person (the buyer) agrees to pay a determined price for the property delivered (Khan et al., 2010:3).[45] The essential elements for a contract of sale, other than the normal requirements for a valid contract, include the intention on the part of the seller to sell and the purchaser to buy and agreement on the thing to be delivered and the price to be paid (Khan et al., 2010:11).

The courts will consider the substance of the agreement as opposed to its legal form in ascertaining the true intention of the parties (Khan et al., 2010:11).

However, in terms of South African common law, the transfer of ownership in an item of property is not a pre-requisite for a valid contract of sale, although generally the intention in concluding a sale agreement is for ownership to be transferred (Khan et al., 2010:4). Delivery or cession of the property must however take place for a valid contract of sale to be concluded.

Consequently, the possibility exists for a valid contract of sale to be concluded where the ownership in an item of property is not transferred to the purchaser. This then begs the question as to what the distinction is between a lease of property and a valid contract of sale, as it is conceivable that the two types of contracts may overlap in this instance.

It must be noted however, that in terms of South African common law relating to contracts of sale, the seller has an ongoing obligation to ensure the purchaser's permanent possession of the property transferred (Khan et al., 2010:26-27). Where it is clear that the parties never intended for the permanent possession to be undisturbed, the courts will likely find that the true intention of the parties was never for the contract to constitute a contract of sale. This differs from the legal position of a lease which is described below.

3.2.2 Contract of lease

According to Khan et al. (2010:71), lease agreements are defined for South African common law purposes as:

> *"…reciprocal agreements between lessors and lessees, in terms of which the lessors bind themselves to give the lessees the temporary use and enjoyment of property, wholly or in part,*

[45] Khan, E., Havenga, M., Havenga, P., Lotz, J., Bradfield, G., Lehmann, K. 2010. *Principles of the Law of Sale & Lease*. Rev. 2nd ed. Cape Town: Juta.

and the lessees bind themselves in turn to pay a sum of money as compensation for that use and enjoyment."

Thus for a valid lease agreement to be concluded, the following essential elements need to be present in the agreement (Khan et al., 2010:71):

1) One of the parties agrees to grant a right of use or enjoyment over ascertained property;
2) The use or enjoyment referred to above should be temporary i.e. for a period mentioned in the agreement; and
3) The person making use of the property should agree to pay a rental in exchange for the benefit of using the property.

It is clear that in terms of the common law a contract can only be a lease if only the right of temporary use or enjoyment of the property is granted to the lessee. The lessee does not obtain an *ius abutendi*: *"the right to consume all or part of the substance of the property itself"* (Khan et al., 2010:72). However, in a contract of sale, this right will usually be transferred to the purchaser.

If the above requirements are not met, but the property is transferred (even though ownership is not transferred) without mention of a temporary right of use, and with no indication that the transferee does not obtain an *ius abutendi*, the contract would most likely constitute a contract of sale in terms of the common law, subject to agreement on the price for the transfer and the other requirements for a valid contract.

3.2.3 Conclusion

In conclusion from a South African legal perspective, it seems as though the first question to consider in determining whether a business arrangement is a lease, sale of property or pure service arrangement is to determine whether the arrangement is a lease according to the above requirements. If it does not meet the above requirements, it would have to constitute a service arrangement or a contract of sale or a combination of the above. In determining if the arrangement is a service arrangement, one should consider whether actual property is transferred to the purchaser/user. If property is transferred and does not constitute a lease as discussed above, it would constitute a contract of sale. If no property is transferred, the agreement would constitute a service arrangement.

In considering business arrangements conceivably falling within the ambit of a lease, mention must be made of the term "royalty" which can be broadly described as a payment for the use of IP. Given the prominence of royalties in the digital economy and the fact that the term is defined in the ITA, it is necessary to analyse the meaning of the term for South African tax purposes.

3.3 MEANING OF THE TERM "ROYALTY" FOR SOUTH AFRICAN TAX PURPOSES

3.3.1 Introduction

For South African tax purposes, a royalty is defined in section 9(1) of the ITA for the purposes of section 9 as *"any amount that is received or accrues in respect of the use, right of use or permission to use any intellectual property as defined in section 23I."*

For the purposes of withholding taxes on royalties levied in South Africa however, the definition is expanded in section 49A(1) to also include any amount that is received or accrues in respect of the *"imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information."*

It is submitted that the definition of a royalty for South African tax purposes can be divided into two parts, namely; the section 9 definition of a royalty and the additional portion included in the section 49A definition relating to the impartation of certain knowledge and the rendering of certain services in connection with the application or use of that knowledge.

The analysis of the interpretation of a royalty for South African tax purposes will proceed by first considering the section 9 definition and then considering the additional inclusions noted in section 49A.

3.3.2 Common law meaning of "royalty"

The definition in section 9 clearly only refers to amounts received for the use or right of use of IP as opposed to amounts received for obtaining a right to the substance of the IP itself, the *ius abutendi* referred to in paragraph 3.2.2. Consequently, only arrangements constituting lease agreements would conceivably fall within the ambit of a "royalty" for the purposes of the section 9 definition.

The 2014 OECD commentary to article 12 confirms this principle in paragraph 1 where it is stated that in principle, *"royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from a letting."*

Although the term "royalty" is defined in the ITA, the interpretation of the definition itself is still open to scrutiny and analysis and it is worthwhile considering existing local and international case law which gives guidance into the common law meaning of the term. The courts may refer to the common law meaning of the term in interpreting the definition included in the ITA.

There is a very limited body of South African case law concerning the meaning of the term "royalty". However *ITC 1735* (supra) does provide some insight into the matter.

In this case the court had to determine whether certain payments made to a professional golfer, relating to his participation in a golf tournament in South Africa should have been taxed as a royalty in terms of the then section 35 of the ITA. Section 35, as it was worded at the time, provided for non-residents to be taxed at 12% on certain amounts deemed to be from a source in South Africa in terms of section 9 of the ITA. Section 9 referred to, *inter alia*, payments made for the use of certain property in South Africa and deemed these amounts to be from a source in South Africa. The relevant property referred to in section 9 at that time was very similar to the property currently included in the definition of IP in section 23I of the ITA. The agreement between the parties allowed the tournament host to make use of the golfer's *"likeness, biographical material, his presence at promotional events and media conferences and repeat television/video utilisation of his participation in the Tournament"* and in return the host agreed to pay what was termed a royalty per the agreement.

The Appellant (the Golfer) argued that the payment was not subject to tax in South Africa on the basis that it constituted a royalty for the purposes of the Double Tax Treaty (DTT) between South Africa and the United Kingdom. The Appellant based this submission on the premise that his name, likeness and biographical material constituted property subject to copyright and that he owned the copyright subsisting therein (payments for the use or right to use any copyright formed part of the definition of a royalty in terms of the then relevant DTT).

The court rejected this argument at 462 on the basis that 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…"* It also

noted that the Appellant did not supply any evidence that the items in question were the result of skill and effort.

In essence the court found that the property was not subject to copyright and thus did not fall within the property listed in the then section 9 of the ITA or in terms of the definition of a royalty in article 11 of the relevant DTT.

The principle to be found in this case is that in interpreting what property would fall within the definition of IP, it is likely that the courts will adopt a restrictive approach in interpreting the definition and only payments made strictly for property listed in the definition of IP would constitute royalties (Buckley, 2012).[46]

Given the dearth of local law relating to the meaning of a royalty for tax purposes (exacerbated by the fact that the section 9 definition of a royalty was only inserted in the ITA in 2012 with the expanded definition for the purposes of withholding taxes being inserted in 2013), it is likely that local courts may also refer to foreign case law for guidance, which although not binding on South African courts, does have persuasive value.

Perhaps the leading international case in this regard is that of *Pierre Boulez v. Commissioner for Internal Revenue.*[47]In this case the United States court had to determine whether amounts received by an orchestra conductor in respect of recordings of orchestral works constituted royalties or payments for services rendered. The agreement between the conductor and the recording studio specifically provided that the recordings would belong to the recording studio, and that the conductor would receive payment based on a percentage of sales of the recordings, described as royalties in the agreement.

The court held that the payments did not constitute royalties, but rather were made as compensation for personal services. It based its decision on the fact that the conductor did not have an ownership interest in the recordings. The principle gleaned from this case as stated by Judge Korner at 593 is 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".*

[46] Buckley, R. 2012. 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. M.Com (Taxation). Dissertation. University of Cape Town.
[47] (1984) 83 T.C. 584

According to Woellner (1996, quoted by Du Toit, 1999:35)[48], generally the features of a common law royalty comprise the following:

"

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) *the payment is made to the person holding the ownership or other rights which enable him to confer that beneficial privilege;*
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) *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) *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 must be noted that the above characteristics are merely indicators of a royalty and are not prerequisites (Buckley, 2012) and it is submitted that the core characteristics which would always need to be present for a payment to constitute a common law royalty would be points 1 and 2, which is confirmed based on the *Pierre Boulez* case (supra) and in the wording of the section 9 definition which does not require the elements in points 3 to 5 to be present.

In summary, it is clear that the above analysis reveals that in order for an amount to constitute a royalty for the purposes of section 9, the payment must be in return for the right to use the property specifically included in the definition of IP in section 23I (as interpreted restrictively) and that that right should not result in the user obtaining an interest in the substance of the property. The ownership of the IP subject to use should not be transferred to the user and should either remain with the grantor or the person allowing the grantor to grant the right of use.

[48] Du Toit, C.P. 1999. *Beneficial Ownership of Royalties in Bilateral Tax Treaties*. Amsterdam: IBFD Publications BV.

3.3.3 Meaning of "property or right of a similar nature" as included in the definition of IP in section 23I of the ITA

Of particular interest in the section 9 definition of a royalty is the reference in the definition of IP in section 23I of the ITA to:

> "
>
> *f) property or right of a similar nature to that in paragraph (a), (b), (c), (d) or (e); and*
>
> *g) knowledge connected to the use of such patent, design, trade mark, copyright, property or right;"*

Based on the above provisions, the question arises as to the nature of the property or knowledge which would fall within the ambit of the above provisions.

The meaning of the phrase "property or right of a similar nature" has been considered by the courts in the *SA Silicone Products (Pty) Ltd* case[49], where Judge Heher stated at 139 that to qualify as property being of a similar nature, the property in question *"shall possess fundamental characteristics common to those possessed by the specifically identified properties"*.

The above suggests that to fall within the ambit of the phrase, the property in question must be more than similar to the other property identified, but rather should share certain fundamental characteristics. The phrase should be restrictively interpreted (Buckley, 2012).

In identifying the common characteristics of property included in the then worded section 9(1)(b)(i) of the ITA, the court in *ITC 1735* (supra) referred to the fact that the property listed in the then section 9(1)(b)(i) (being property also included in the abovementioned definition of IP) all had a single characteristic in common: they were rights designed to protect the original intellectual work of their creators. In addition, in the *SA Silicone Products (Pty) Ltd* case, Judge Heher also stated at 139, in reference to property contained in the then worded section 11(gA) (being property also included in the abovementioned definition of IP), that *"the common natures of the identified properties…embrace their intellectual origins, i.e. their derivation from a creative mind."*

By implication, it is submitted that the common fundamental characteristic of property listed in the then section 11(gA), and also in the definition of IP, is that the property must have been derived from creative or intellectual efforts (Buckley, 2012). Thus it is submitted that for other

[49] *CSARS v SA Silicone Products (Pty) Ltd* (2004) 66 SATC 131

property not specifically mentioned in the definition of IP to fall within the ambit of that definition, such property would have to relate to the *protection* of an original work derived from creative or intellectual efforts.

This brings us to the concept of "know-how" which, although not defined in the ITA, is encapsulated in paragraphs (f) and (g) in the definition of IP in section 23I and also in the definition of a royalty in section 49A (as relates to the impartation of certain knowledge).

3.3.4 Know-how

The term "know-how" is defined in Black's Law Dictionary[50] 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."*

There is limited case law on the interpretation of the meaning of "know-how" for tax purposes in South Africa, although the term is recognised and discussed in the 2014 OECD commentary to article 12.

The nature of know-how was considered in *ITC 1190*[51] where the court referred to the English case of *Jeffrey (HM Inspector of Taxes) v Rolls-Royce Ltd*[52] which noted that know-how was a capital intangible asset and stressed that the sale of know-how did not constitute the parting with an asset, although there would maybe be a diminution in the value of the asset. The court in *ITC 1190* also approved of the remarks of Lord Denning in the English case of *Evans Medical Supplies Ltd v Moriarty (HM Inspector of Taxes)*[53] indicating support for the contention that the sale of know-how did not constitute the parting with an asset.[54]

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[50] Garner, B.A. Ed. 2009. *Black's Law Dictionary.* 9th ed. St Paul: West.
[51] (1970) 35 SATC 188(T)
[52] (1962) 40 TC 443
[53] (1958) 37 TC 540
[54] Lord Denning states at 589: *"What, then, is the position of knowhow 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 knowhow 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 knowhow is inseparable from the knowhow 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 knowhow 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 knowhow always remains entitled to use it himself, as was the case here."*

Furthermore, the court referred to remarks made by Lord Denning in *Musker (HM Inspector of Taxes) v English Electric Co Ltd*[55] at 582 where he indicates that know-how can be sold outright, but only in the instance where the seller withdraws from the business outright and agrees not to use the know-how or goodwill to the prejudice of the purchaser. The above principles were also confirmed in *ITC 1193*.[56]

From the above case law, it appears that know-how is an intangible asset which as a rule is incapable of being transferred outright to a purchaser unless the business as a whole is disposed. In addition, the above cases also imply that know-how relates to some form of secret or undivulged knowledge, as know-how that is freely available would have no value.

It is submitted that know-how, by its nature, can only come about by creative or intellectual processes and as such shares one of the common characteristics of the property identified in paragraphs (a) to (e) of the definition of IP.

Given the view of the courts that the phrase "*property or right of a similar nature*" should be interpreted restrictively, it is also submitted that the mere transfer of knowledge would not fall within the ambit of the phrase. It must arise as a result of creative efforts, implying that it should be new knowledge undivulged to other parties. This is supported by the view in the 2014 OECD commentary setting out the characteristics of "know-how" and distinguishing it from mere service arrangements, notably that the information transferred should be confidential or undivulged (see 3.4.2).

In conclusion, it is submitted that for South African tax purposes, know-how constitutes an intangible asset comprising undivulged knowledge which arises as a result of creative or intellectual efforts.

In addition, where knowledge transferred is not similar to property identified in paragraphs (a) to (e) of the definition of IP, but is transferred relating to an arrangement where the use of other property listed in paragraphs (a) to (f) of the definition of IP is granted to another contracting party, this knowledge would also fall within the definition of IP as defined above. It is submitted however, that the transferred knowledge referred to above would have to possess the characteristics of know-how discussed above to fall within the ambit of the definition of IP.

[55] (1964) 41 TC 556
[56] (1972) 35 SATC 220(N)

3.3.5 Show-how

With regard to the second part of the definition of royalties as included in section 49A, the following phrase is of importance: "*the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information.*"

The definition of a royalty in section 49A includes the impartation of certain knowledge and the rendering of certain services in connection with the use or application of know-how. It must be noted that this addition appears to be a specific tax addition and falls outside the common law meaning of a royalty.

It is submitted that the impartation of knowledge referred to in the definition refers to "know-how" as discussed above and for knowledge to fall within the ambit of the definition, it would have to possess the characteristics described above.

As relates to the services component, it is important to determine what type of services would fall within the scope of the section 49A definition of a royalty.

The services referred to in section 49A have been termed so-called "show-how" by various commentators (Buckley, 2012). In terms of the wording of section 49A it is key to note the use of the phrase of *"in connection with"*. This wording already limits the scope of the services as the phrase has been considered by the courts.

The phrase was considered by the court in *Rabinowitz & another v De Beers Consolidated Mines Ltd & another*[57], where Judge Schreiner notes at 631:

> *"Expressions like "in respect of" and "in connection with", though they may sometimes be used to cover a wide range of association, must in other cases be limited to the closer or more direct forms of association indicated by the context."*

This statement was approved by the Appellate division in *Secretary for Inland Revenue v Wispeco Housing (Pty) Ltd*.[58]

In light of the above, it is clear that the context of the phrase as it is used in section 49A must be ascertained. Based on the context used, it may be necessary to give a restricted interpretation

[57] (1958) (3) SA 619
[58] (1973) 35 SATC 14

to the phrase such that there should be a close or direct association between the services rendered and the use or application of the know-how concerned.

The phrase is used in section 49A in such a manner so as to link certain services, not to the know-how in question, but rather to the application or use of that know-how. Given that know-how is confidential by nature and can only be used by its original creator or by the person(s) with whom it has been shared, it is submitted that such use is quite restricted. Any services rendered in relation to such use or application would have to arise directly as a result of the use of the know-how. The services and the use or application of the know-how are inextricably linked.

Consequently, given the restricted nature of the use of know-how, and the limited nature of the services that could be linked to its use, it is submitted that a restricted interpretation of the phrase "in connection with" should be adopted in section 49A. It is submitted that, in order for services to fall within the ambit of section 49A, such services would have to be directly or closely associated with the application or use of the specific know-how concerned.

This direct association implies that a relationship of causality should exist between the services and the use or application of the know-how. The concept of causality for tax purposes has been considered in *Stander v Commissioner for Inland Revenue.*[59] In this case, a certain Mr Stander, who worked as a bookkeeper for a motor dealership constituting a franchisee of Delta Motor Corporation (Pty) Ltd (Delta), won a prize from Delta for the quality of his work.

The court had to decide whether the prize received by Mr Stander was required to be included in his taxable income in terms of, *inter alia,* paragraph (c) of the definition of gross income in section 1 of the ITA, which included amounts *"in respect of services rendered"* in gross income. The court held that the meaning of these words reflected that *"there had to be a causal relationship between the amounts received and the services rendered"* for the amounts to fall within paragraph (c) of definition of gross income. The services had to be the *causa causans* of the income received.[60]

[59] (1997) 59 SATC 212

[60] Friedman JP stated at 220: *"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."*

The principle to be derived from this case is that in order for a causal relationship to be present between two occurrences, there should be a strong link between the two; i.e. one occurrence should be the *causa causans* or immediate cause (Garner, 2009:248) in relation to the other.

In light of the above, it appears as though in determining if services rendered are causally linked to the application or use of the associated know-how, one has to enquire if such use or application is the immediate or dominant cause of the services rendered.

Only where this question is answered in the affirmative, would the services fall within the ambit of the definition of a royalty in section 49A. Given the confidential nature of know-how and the fact that it can only be used by persons with whom it has been shared, it is submitted that only services pertaining to situations where know-how has been transferred and where the recipient requires assistance in **applying** that knowledge itself, would fall within the ambit of the considered services.

Until now we have considered the meaning of a royalty for South African tax purposes. However, it is also necessary to consider the meaning of a royalty for the purposes of the OECD Model Tax Convention in order to determine whether South Africa's current treaty network, together with the source rules contained in section 9 of the ITA, are adequate in relation to the taxation of royalties.

3.4 MEANING OF THE TERM "ROYALTY" IN TERMS OF THE OECD MODEL TAX CONVENTION

3.4.1 Introduction

The OECD Model Tax Convention defines a royalty in article 12 as meaning any payment *"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 cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."*

It is important to distinguish a royalty from other transaction types (such as sales, services and leases etc.) for the purposes of the correct characterisation of income from a treaty perspective and from a South African domestic law perspective. This distinction has already been discussed from a South African domestic law perspective.

As noted in 3.3.2, the 2014 OECD commentary confirms the South African legal position that a royalty is in essence, income from a letting. It is however narrower than a normal letting in that it represents income from the letting of a specified type of property.

Paragraph 8.2 of the 2014 OECD commentary to article 12 states that where an amount is paid to acquire full ownership of property contained in the above definition, such a payment cannot constitute a royalty as it cannot be consideration "for the use of, or the right to use" that property.

Paragraph 8.1 states that the royalty definition does not apply to payments made to someone *"who does not himself own the right or the right to use the right"*.

Again, these principles confirm the view that a royalty can only constitute a payment for the use, or right to use property and cannot apply to arrangements where the payer acquires a right to the substance of the property.

3.4.2 Know-how and show-how in the context of the OECD commentary

One point of differentiation in the OECD Model Tax Convention definition of a royalty and the definition of a royalty for South African tax purposes, is that the definition of a royalty in section 9 of the ITA specifically includes payments for the use of *"knowledge connected to the use of such patent, design, trade mark, copyright, property or right;"* and the definition in section 49A includes any amount that is received or accrues in respect of the *"imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information."* The OECD Model Tax Convention definition only refers to "*information concerning industrial, commercial or scientific experience."*

The 2014 OECD commentary to article 12 does however expand on this phrase included in the definition, referring to it as so-called "know-how". The concept of know-how has been discussed from a South African domestic law perspective. However, for the purposes of the 2014 OECD commentary to article 12, paragraph 11 alludes to the meaning of "know-how" as being *"information that has not been patented and does not generally fall within other categories of intellectual property rights. It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has*

practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived."

The commentary distinguishes the provision of know-how from a normal service arrangement in that in a know-how contract, the grantor is not required to apply the knowledge (undivulged to the public) himself, whereas in a service arrangement the person rendering the service applies his know-how in performing work for the other party (paragraph 11 to article 12 of the 2014 OECD commentary).

The key characteristics of know-how are thus the following (paragraph 11 to article 12 of the 2014 OECD commentary):

1) Concerns **confidential information** that **already exists**;
2) Concerns the **transfer of special knowledge** as opposed to the rendering of services requiring the use of that knowledge;
3) Usually in a know-how arrangement, **limited application of the knowledge by the grantor is required**, only the transfer of the knowledge is important; **(own emphasis)**

These characteristics align with the South African legal interpretation of know-how.

It is clear that from the above analysis that the provision of know-how does not constitute a service arrangement, nor does it constitute the outright transfer of property as know-how itself generally cannot be disposed by the grantor without disposing of his whole business (or a portion thereof). It can only be shared (see 3.3.4). In terms of the OECD Model Tax Convention, it is regarded as forming part of the royalty definition in article 12.

Based on the above, it is submitted that the concept of know-how as espoused in the 2014 OECD commentary, and the understanding of the term for South African tax purposes are the same. It is submitted that know-how falling within the ambit of article 12 of the OECD Model Tax Convention should constitute IP for the purposes of the ITA, and payments made for the use of such know-how should constitute royalties for South African tax purposes in terms of the section 9 and section 49A definitions of a royalty.

Section 49A however also refers to services rendered in connection with the use of know-how. Such services are not included in the OECD Model Tax Convention definition of a royalty and would ordinarily be regarded as falling within the business profits article of the OECD Model Tax Convention.

In terms of paragraph 11.5 of the 2014 OECD commentary to article 12, a software arrangement will usually only constitute a know-how arrangement where it provides for the transfer of confidential information concerning the ideas and principles underlying the program.

3.5 APPLICATION IN THE CONTEXT OF SOFTWARE ARRANGEMENTS

Now that the meaning of a royalty has been analysed above, it is important to analyse the meaning of a royalty specifically in the context of certain software arrangements. The 2014 OECD commentary to article 12 has issued specific guidance in this regard. Although the OECD commentary is not legally binding in terms of South African domestic tax legislation, it is submitted that it is at least persuasive in providing guidance to South African courts as evidenced by the numerous tax judgements making reference to the guidance. This is especially so given the commonalities in the interpretation of the terms "royalty" and "know-how" by the OECD (as contained in the 2014 OECD commentary) and the South African courts as discussed in this chapter.

3.5.1 Sale and lease versus royalty

As concluded in chapter 2, at least a portion of the payment for the use of software, as opposed to obtaining all the rights to the substance of the software, will usually constitute a royalty on the basis that such portion would constitute a payment for the use of the underlying copyright. The 2014 OECD commentary confirms this point.[61]

However, due to the electronic nature of software, in most cases it is necessary to make copies of a program to merely facilitate its operation. Consequently in situations where customers purchase copies of software programs merely to use the specific copy, the copyright holder has to grant a limited copyright to facilitate the operation of that program on the customer's computer. In this case, it may be argued that any payment made relating to that limited copyright may constitute a royalty based on the OECD commentary above. However, paragraph 14 of the 2014 OECD commentary to article 12 confirms that in situations where a user obtains all the rights to a program copy, excluding full copyright, the rights relating to

[61] Paragraph 13.1 of the 2014 OECD commentary to article 12 states: *"Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright."*

copying the program to facilitate its operation should be disregarded in analysing the character of the payment.

In conclusion, in analysing the key points to differentiate a royalty from a sale in the context of software arrangements, one has to first analyse the nature of the rights acquired by the transferee in the arrangement. Secondly, one has to distinguish between the copyrighted program and the copyright itself.

Support for the view that the copyright and copyrighted article should be considered separately for tax purposes can be found in the Indian case of *Motorola Inc vs DCIT*.[62]In this case the court held that, in determining if a payment made for the use of an item subject to copyright constituted a royalty for Indian tax purposes, the key distinction that had to be made was whether one was paying for the use of the copyright, or simply for the use of the material that was protected by copyright. Only a payment for the use of the copyright would constitute a royalty for Indian tax purposes.

Du Toit (1999:48) also supports this view and states the following:

> *"It is necessary to distinguish between payment for the use or right to use the copyright, which is a royalty, and payment for use of the software only, which is similar to the purchase of a commodity, therefore not a royalty …"*

From the above, four possible scenarios present themselves.

1) Where the transferee acquires all the rights to the software, including full ownership of the copyright, the transaction would clearly constitute a sale of both the program copy and the copyright.

2) Where the transferee acquires the right to the software but only the right to use the copyright (as opposed to full ownership of the copyright) for the purposes of facilitating the operation of the copyrighted software, the payment made would constitute a sale.

3) In the situation where the transferee acquires the right to the software but only the right to use the copyright (as opposed to full ownership of the copyright) for purposes not limited to the facilitation of the operation of the copyrighted software, the payment made would have to be analysed into its components, but a significant component

[62] (2005) 95 ITD 269

would constitute a royalty (subject to the exclusions on the use of copyright discussed in chapter 2).

4) Where the transferee acquires the right to the program copy, but does not receive any copyright, the transaction would constitute a sale (as would be the case in certain distribution arrangements).

Problems do arise however in the context of software arrangements where rights falling within the definition of a royalty are transferred in an arrangement that appears to be a sale. For example, the exclusive granting of all rights to an item of software for a limited period, or for a limited geographical area. The 2014 OECD commentary notes in paragraph 8.2 to article 12 that each case should be examined based on its particular facts in light of a country's IP law and domestic legislation as to what constitutes an alienation. In situations where the right to an item of software is given for a limited period, the components of the payment relating to the copyright and the copyrighted article should be evaluated separately in order to determine if the arrangement constitutes a lease of the copyrighted article (being the software program) as opposed to a sale. If the transferee obtains a copy of the copyrighted article and has the temporary right of use of such article (after which it must be returned or destroyed or the item stops operating), it is likely that a portion of the payment would constitute a lease. Further analysis would have to be made to determine the treatment of the portion of the payment relating to the actual copyright in terms of points 2 and 3 above. If the lessee obtains a limited copyright to facilitate the operation of the program, then it is submitted that the whole payment should be treated as a lease payment as in point 2 noted above.

As noted above, scenario 1 may be complicated further where the full ownership of the copyright is transferred and where the transfer of the right is granted for a specific period or for a specific geographical area. But in the case of a geographical limitation, it is submitted that the commentary in paragraph 8.2 of the 2014 OECD commentary to article 12 is correct in stating that even though the rights transferred may be limited, the fact remains that the rights transferred still represent distinct and specific property, ownership of which has been transferred. Thus it is submitted that the transfer would still constitute a sale in line with the reasoning in paragraph 8.2 of the 2014 OECD commentary to article 12.

However, in the case of a time-limited right granted for a period of less than 50 years, it is submitted that this may more likely constitute a royalty arrangement, in that once the time period elapses, the copyright will revert to the copyright holder. During the period of the

agreement, the transferee will in essence only have a right of use of the copyright which will ultimately revert to the copyright holder. The transferee will not have acquired a right to the substance of the copyright.

Now that royalty arrangements have been differentiated from sale arrangements and lease arrangements, it is also necessary to differentiate royalty arrangements from service arrangements.

3.5.2 Service versus royalty

From the discussion in paragraph 3.2 it was concluded that for South African common law purposes, in order to correctly classify an arrangement as being a lease, sale of property or service arrangement, one first has to determine if the arrangement is a lease, and if it is not, then conclude if it is a sale agreement or a service agreement.

Again, as discussed in paragraph 3.2, an arrangement can only constitute a lease if there is an agreement whereby one party grants to the other the temporary right of use of an ascertained item of property in exchange for a determinable rent. Consequently, where an arrangement does not provide the other contracting party with a right of use to certain IP (including know-how arrangements), the payments under that arrangement cannot constitute royalties.

In addition, where no property is transferred in terms of the arrangement, the arrangement cannot constitute a sale and is therefore likely to constitute a service arrangement.

3.5.3 Mixed contracts

Certain software arrangements may also be concluded in the form of so-called “mixed contracts” where a number of the different elements discussed above may be present (the contract may envisage the sale of software together with an additional services component, for example).

In such instances, paragraphs 11.6 and 17 of the 2014 OECD commentary to article 12 state that, where possible, the consideration payable in terms of the contract should be apportioned according to the information in the contract, or by means of some reasonable apportionment and each component should be analysed separately for tax purposes. However, if one element of the contract clearly constitutes the main purpose of the contract and the other elements are merely ancillary in nature, then the entire contract consideration should be classified according to the treatment applicable to the principal element.

This is in line with the general apportionment principles applied for tax purposes in South Africa. Although there is no specific case law on the apportionment of an item of income into its various components as described above for South African tax purposes, the issue of apportionment of income for the purposes of determining the source thereof and as to the distinction between capital and revenue has been considered by the courts.

In the *Lever Brothers* case (supra), the court held that the source of a receipt is not the location from which it was received but *"the originating cause"* of the income and this originating cause is the *"work which the taxpayer does to earn the income, the quid pro quo he gives in return for which he receives the income"*. This approach is further supported by the judgements in *Tuck v CIR*[63] and *CSARS v McRae*[64], where the courts allowed the apportionment of a receipt into its capital and revenue components.

In considering the apportionment of an item of income into its capital and revenue components, the courts have held that when considering the *quid pro quo* for a receipt of income, it is possible that there may be mixed elements of capital and revenue inherent in the work done by the taxpayer and therefore in the receipt of the income. Where this is the case, the test to be applied is to seek and give effect to the dominant factor operating to induce the transaction (*COT v Levy*[65] and *CIR v Paul*[66]).

From the above, it is likely that the apportionment of an item of income into its various income components for tax purposes will be supported by South African case law where it is clear a single receipt relates to more than one distinct income characterisation. Furthermore, it is likely that where there is more than one *quid pro quo* in respect of a receipt, and it is clear that one of the causes of the receipt is insignificant, the courts will classify the whole receipt according to the dominant *quid pro quo* in the transaction.

As alluded to in chapter 2, where a program is copied solely to facilitate the private usage of the software, such an act may constitute the "use of a copyright" despite the provisions of section 19B of the Copyright Act. However, it is submitted that the use of the copyright is merely ancillary in that case for tax purposes and that no portion of any payment received in

[63] (1988) 50 SATC 98
[64] (2001) 64 SATC 1
[65] (1952) (2) S.A. 413 (A.D.) 97
[66] (1956) (3) S.A. 335 (A.D.) 98

that arrangement should be allocated to the use of the copyright based on the arguments noted above.

3.6 CONCLUSION

This chapter has attempted to broadly distinguish the main income characterisations (sales, service arrangements, leases and royalties arrangements) relevant in the context of software arrangements for the purposes of forming a foundation to evaluate the current source rules applicable to software arrangements contained in section 9 of the ITA and as espoused in the common law.

In addition, the meaning of the term "royalty" was considered for South African tax purposes and for the purposes of the OECD Model Tax Convention and it is submitted that with the exception of show-how as espoused in section 49A of the ITA, the concepts of a royalty and know-how are consistent in the OECD Model Tax Convention and the ITA.

Specifically in relation to software arrangements, a distinction should be made between the copyrighted article and the copyright itself. Payments made for both elements should be evaluated separately and where a combination of elements is present in an arrangement, the associated payment should be apportioned into its various components, unless one of the components is clearly insignificant, in which case that component should be disregarded for characterisation purposes.

CHAPTER 4: SOURCE-BASED TAXATION IN SOUTH AFRICA IN THE CONTEXT OF SOFTWARE-RELATED ARRANGEMENTS

4.1 INTRODUCTION

South Africa has adopted a system whereby South African tax residents are taxed on their worldwide income and capital gains, subject to any applicable exemptions and treaty relief. However South Africa only taxes non-residents in respect of income and certain capital gains having a source in South Africa, subject to available exemptions and any applicable treaty relief.

As discussed in chapter 1, given the rise of the digital economy and the ability of organisations to derive income from a location without having a significant business presence therein, it is necessary to assess whether the current source rules implemented by South Africa are still appropriate, especially in the context of software arrangements.

There is no definition of the term "source" in the ITA, however section 9 of the ITA provides rules for determining when an item of income is deemed to be from a source within South Africa. In addition to the provisions of section 9, there is a significant body of case law setting out principles for determining the source of various types of income. However, certain case law may have been superseded by the provisions of section 9. For the purposes of this chapter, the common law meaning of source in relation to the various income categories discussed below will be referred to as the true source of the income. The section 9 meaning of source will be referred to as the deemed source of the income.

This chapter will briefly discuss the various rules applicable in South Africa in determining the source of income in relation to the categories of income identified in chapter 3.

4.2 THEORETICAL JUSTIFICATION FOR SOURCE-BASED TAXATION

In relation to software arrangements, and digital transactions in general, it is first important to determine if there is any theoretical justification for a country to tax income where the recipient of the income is not resident in that country and/or has no physical presence in that country.

In this regard, literature highlights two academic theories supporting the basis of source-based taxation. The first of these theories is the so-called "sourcing theory". This theory was developed by an Italian tax academic at the turn of the 20th century and postulates that income is linked to an "energy or force of production" and that there is a causal link between the two.

It states that a country should have taxing rights in respect of income if activities giving rise to that income are carried out within that country's territory (Hongler & Pistone, 2015: 17-18).[67]

This theory is widely accepted as justifying the source-based taxation principle and the theoretical validity thereof remains unchanged. The existence of a real link between the location wherein activities giving rise to income are carried out and the income itself, as well as the right of such jurisdiction to tax that income, should not be questioned where the presence of a non-resident in that jurisdiction is *"not merely occasional"* (Hongler & Pistone, 2015: 18).

In light of this theory, there is justification for taxing income arising from software arrangements in South Africa where activities giving rise to that income occur in South Africa. This need not be physical activities nor activities conducted by the enterprise itself, but should only be activities or operations which take place within the jurisdiction of South Africa.

Similarly, another theory known as the benefit theory also supports the premise of source-based taxation. According to Pinto (2006, quoted by Hongler & Pistone, 2015: 19-21), this theory postulates that the *"taxes are the price paid for all state services by all taxpayers taken together and countries obtain their taxing rights based on the services (benefits) provided"*. Essentially this theory recognises that taxing rights should be allocated based on economic allegiance and that the country which provides services or benefits necessary for income to be derived should be entitled to tax the associated income (Hongler & Pistone, 2015: 19-21). This theory is widely accepted and again supports the notion that income arising from software arrangements derived from activities or consumption in South Africa should at least be partially taxed in South Africa.

Vogel (1988, quoted by Hongler & Pistone, 2015:20) notes that it *"cannot convincingly be denied that providing a market contributes to the sales income at least to some extent as providing the goods does. There is no valid objection, therefore, against a claim of the sale state to tax part of the sales income."*[68]

Pinto (2003: 22) argues that source-based taxation is theoretically justifiable in the electronic commerce context. He notes that although in most electronic commerce cases the only contribution of a source country from an economic perspective would be its customer base or

[67] Hongler, P. & Pistone, P. 2015. *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy.* IBFD Working paper 20 January 2015. IBFD.
[68] Vogel, K. 1988. Worldwide vs. Source Taxation of Income – A review and Re-evaluation of Arguments (Part III). *Intertax*. 16 (11): 401.

market, indicating little benefit provided by the source country, there is substantial support for the view that the business deriving the income benefits substantially from the infrastructure (e.g. telecommunications infrastructure) and legal system of the source country.

Given the above, it is clear that there is theoretical justification for South Africa taxing income arising from software arrangements where the consumer of the service or product is situated in South Africa despite the vendor not having a physical presence in South Africa.

4.3 CONCEPT OF A PERMANENT ESTABLISHMENT FOR SOUTH AFRICAN TAX PURPOSES

An understanding of the concept of a PE for South African tax purposes is crucial in the evaluation of the source principles currently applied by South Africa. The concept is core in determining the taxation of non-resident business income in South Africa and will thus be explored prior to engaging in an analysis of the current source rules embodied in South African case law and the ITA.

Broadly speaking, where a non-resident enterprise derives business income from South Africa, and that enterprise is resident in a country with which South Africa has concluded a DTT, that enterprise is only subject to tax on that income in South Africa if it maintains a PE in South Africa for the duration of the period during which the income is earned.

The term “permanent establishment” is defined in section 1 of the ITA with the definition referring to the concept of a PE as defined from time to time in article 5 of the OECD Model Tax Convention on Income and on Capital.

The OECD Model Tax Convention is incorporated into South African tax law by means of the various DTTs South Africa has concluded globally which are based on the OECD Model. The legal status of a gazetted DTT as approved by parliament is that it is deemed to be enacted as law under the ITA in terms of section 108(2) read with section 231 of the Constitution of the Republic of South Africa (1996). As regards the OECD commentary relating to the OECD Model, South African courts, as noted in the case of *Secretary for Inland Revenue v Downing*[69] and *ITC 1503*[70], have held that such commentary may be used in interpreting tax treaties.[71]

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[69](1975) 37 SATC 249.

[70](1990) 53 SATC 342(T).

[71] Chaffey, A. 2014. Permanent Establishment dilemma in the Digital Economy. Magister Commercii. Minor Dissertation. University of Johannesburg.

Consequently the OECD commentary, as to the interpretation of the meaning of a PE, is relevant for South African tax purposes.

Article 5(1) of the 2014 OECD Model Tax Convention states that a PE means *"a fixed place of business through which the business of an enterprise is wholly or partly carried on"*.

Articles 5(2) and 5(3) provide specific inclusions as to what is considered to constitute a PE and article 5(4) provides a list of activities which are deemed not to constitute PEs, with one of the key exclusions constituting activities of a preparatory or auxiliary nature.

Paragraph 24 of the 2014 OECD commentary to article 5 notes that *"it is often difficult to distinguish between activities which have a preparatory or auxiliary nature and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits"*. In addition, the activities of the fixed place of business must be carried on for the enterprise.

Articles 5(5) and 5(6) provide guidance as to when a business carried on by an agent would constitute a PE.

As the emphasis of this dissertation is to evaluate the current source rules in relation to software arrangements, this chapter will proceed to evaluate the relevant components of the PE definition relevant to software arrangements.

The definition of a PE per the OECD Model Tax Convention implies certain requirements, all of which must be met in order for an enterprise to qualify as a PE, namely:

1) <u>The enterprise must have a fixed place of business or some physical presence in the "host" country;</u>

   The enterprise must operate from a fixed location in the "host" country. In determining this point, the context of the business should be understood and the main requirement is that the *"business should commercially and geographically consist of a coherent whole"* (Olivier & Honiball, 2011:337-338)[72]. Business must be carried on through a physical location situated in the host country.

   Paragraph 6 of the 2014 OECD commentary to article 5 also provides that a PE can only be deemed to exist where the place of business has a degree of permanence. The

[72] Olivier, L. & Honiball, M. 2011. *International Tax A South African Perspective.* Cape Town: Siberlink.

word 'permanent' is used in *"contradistinction to a merely temporary or occasional use of premises for purposes of trade or business"*.[73]

Experience has shown that PEs have not normally been considered to exist where the place of business was sustained for a period of less than six months. However exceptions do apply where the activities are of a recurrent nature, in which case the period during which the place is used, as well as the frequency of that use, should be considered in totality. Also, exceptions apply where the activities constitute a business carried on exclusively in that country (Olivier & Honiball, 2011:338-339).

In the context of software arrangements, it is clear that many of the activities giving rise to business income need not be physically rendered in the jurisdiction where the services or goods are consumed or used. This presents a problem in the application of the PE concept to software arrangements as no fixed place of business may be established in the jurisdiction where the services or goods are used or consumed. The 2014 OECD commentary recognises (paragraph 42.2 to article 5) that automated equipment may give rise to a PE in certain circumstances, but it also notes that a distinction must be made between the computer equipment and the *"data and software which is used by, or stored on, that equipment"*. The same paragraph recognises that software itself cannot have a location, but rather the server which houses the software will have a location that could constitute a fixed place of business.

The OECD Model Tax Convention thus recognises that a PE may arise in a jurisdiction, in the context of a software arrangement, where the server which houses that software is located in that jurisdiction. In addition, paragraph 42.4 to article 5 of the 2014 OECD commentary provides that in order for a server to become fixed for the purposes of the definition of a PE, it must be located at a *"certain place for a sufficient period of time"*.

2) <u>The place from which business is carried on should be at the disposal of the enterprise;</u>

The 2014 OECD commentary to article 5 (paragraph 4) provides that as long as an enterprise *"has a certain amount of space at its disposal which is used for business activities"*, this is sufficient to constitute a place of business. It does not necessarily matter if the premises are exclusively used for the business or not, whether the premises

[73] *Transvaal Associated Hide and Skin Merchants v CIT Botswana* (1967) 29 SATC 97

are situated in the business facilities of another enterprise or if the enterprise has a legal right to the premises.

Although the definition of a PE requires an entity to operate at a place through which that entity's business is carried on, it does not require the establishment to be that of the entity in question.[74]

In the context of software arrangements, the 2014 OECD commentary (paragraph 42.3 to article 5) notes that the server which houses the software must be at the disposal of the enterprise in order for the server to constitute a PE. This largely eliminates servers operated by Internet Service Providers (ISPs) which simply allow users to host software or a website on the server, resulting in the server not being at the disposal of the user.

3) Business should be carried on through that fixed place

The business of the enterprise itself must be carried on through the fixed location. The 2014 OECD commentary (paragraph 7 to article 5) states that the activity carried on need not be of a productive character. However, the purpose of the fixed place of business must be to serve the business activity, not to be subject to business activities (paragraph 11 to article 5 of the 2014 OECD commentary).

In the context of software arrangements, it is thus important to establish the nature of the activities performed on the server located in a given jurisdiction, as where these activities relate to essential and significant components of the business of an enterprise (e.g. concluding sales contracts), such activities will constitute business carried on through that server (paragraphs 42.7 and 42.8 to article 5 of the 2014 OECD commentary). Where the activities fall within the ambit of activities considered to be preparatory or auxiliary activities as envisaged in paragraph 4 of the definition of a PE (e.g. advertising), such activities may not constitute business carried on. The 2014 OECD commentary notes (paragraph 42.5 to article 5) that this question should be considered on a case-by-case basis.

The above requirements clearly require a business to have a physical presence in the host country in order for a PE to come into existence. This creates problems in applying the above requirements in the context of software arrangements as it is possible to conduct business by means of such arrangements in a country without operating from a physical location in the

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[74] *Oceanic Trust Co. Ltd N.O. v CSARS* (2011) 74 SATC 127

country. As a result, the OECD has made certain amendments to the OECD commentary to provide guidance with regard to electronic commerce. Although the commentary provides guidance as to when certain software arrangements may give rise to a PE, the guidance still requires a physical presence in the host country; by means of the enterprise having a physical server located in the country which is at its disposal and through which it conducts business. The result is that the majority of non-resident enterprises deriving income in the form of business profits arising from software arrangements where consumers are located in South Africa, will not be subject to tax in South Africa as most of these businesses will not maintain such servers in South Africa.

It is clear that the current PE concept as incorporated into South African tax law does not adequately align itself with the sourcing and benefit theories discussed in 4.2 in the context of software arrangements, which do not necessarily require physical presence in order for taxing rights to be allocated to a given jurisdiction.

4.4 SOURCE RULES IN SOUTH AFRICA

4.4.1 Sales transactions

True source of income

The leading principle in determining the source of income in South Africa is derived from the *Lever Brothers* case (supra) wherein the court determined that the source of a receipt is the originating cause of the income, which is the *quid pro quo* a taxpayer gives in return for the income.

The courts have held that the term "source" is not a legal concept, but rather something which the *"practical man would regard as a real source of income"*. Ascertaining the actual source of a receipt is a *"practical hard matter of fact"*.[75]

In determining the originating cause of an amount received, one should consider if the receipt was caused by the productive employment of capital, the taxpayer's intellect and labour or a business carried on by the taxpayer.[76]In the case of a business with a multiplicity of activities, the source of the income is all the business activities in combination.[77]It is thus necessary to

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[75] *Liquidator, Rhodesia Metals Ltd v COT, Southern Rhodesia* (1938) 9 SATC 363
[76] *Liquidator, Rhodesia Metals Ltd v COT* (supra); *CIR v Lever Brothers & Unilever Ltd* (supra)
[77] *Transvaal Associated Hide and Skin Merchants v CIT Botswana* (supra)

determine the dominant cause of the income. The location of the dominant cause of the income will be the source of the receipt.[78]

Consequently, in the case of sales transactions applicable to software arrangements, the courts would look to the activities performed by the business to determine the dominant cause of the sales income, and the location of the dominant cause will be the source of the income. This so-called "activities" test has been applied by the courts in *CIR v Epstein*[79] and *Transvaal Associated Hide and Skin Merchants v CIT Botswana* (supra). It must be noted however that there is no fixed rule for determining the source of an item of income and each case should be considered in light of its own facts.

The apportionment of a receipt in the case where there is more than one dominant originating cause or where the dominant cause is situated in more than one country is possible, but the question has not been decided by the courts (*Transvaal Associated Hide and Skin Merchants v CIT Botswana* (supra); *CIR v Epstein* (supra)).

In the case of sales transactions applicable to software arrangements, where the originating cause of income is the mere purchase and sale of products, the source of the transaction will most likely be the country in which the goods are sold (*CIR v Epstein* (supra); *Liquidator, Rhodesia Metals Ltd v COT* (supra)) or where the sales contracts are habitually made.[80] This principle is difficult to apply in the context of software arrangements. The location of the sale could be anywhere in the world, given that a contract may be concluded by a customer on his home computer, but the software accepting the information may be located on a server in another country. It is clear that current case law has not yet adequately considered the application of the general principles in the context of the digital economy. It is submitted that the current case law principles are incapable of being applied with certainty in the current digital economy in relation to these type of sale transactions.

However, in sales transactions where products are developed and then sold, it is submitted that the originating cause of income derived in such transactions would be the development of the product and the so-called productive employment of capital (*Liquidator, Rhodesia Metals Ltd v COT* (supra); *Transvaal Associated Hide and Skin Merchants v CIT Botswana* (supra)).

[78] *CIR v Black* (1957) 21 SATC 226; *Transvaal Associated Hide and Skin Merchants v CIT Botswana* (supra)
[79] *CIR v Epstein* (1954) 19 SATC 221
[80] *Lovell and Christmas v Taxes Comr* (1908) AC 46

The principle in such a scenario is arguably still applicable in the digital economy as the development of a product still has to take place in a fixed geographical location(s). Where development takes place in numerous locations, the apportionment principles noted above may have to be applied.

Deemed source of income

With regard to the deemed source rules applicable to sales transactions in section 9 of the ITA, section 9(2)(k) provides the following:

> *"An amount is received by or accrues to a person from a source within the Republic if that amount—...*
>
> *k) constitutes an amount received or accrued in respect of the disposal of an asset other than an asset contemplated in paragraph (j) if—...*
>
> *ii) that person is not a resident and that asset is attributable to a permanent establishment of that person which is situated in the Republic; or..."*

Thus for the disposal of an item of movable property to be deemed to be from a source within South Africa, such an asset has to be attributable to a PE of a non-resident in South Africa.

Given that sales transactions would ordinarily constitute business profits in terms article 7 of the OECD Model Tax Convention, tax residents of countries with which South Africa has negotiated DTTs would only be subject to tax in South Africa in respect of such income if they maintained a PE in South Africa.

However, where the recipient is not a resident of a country with which South Africa has concluded a DTT, sales income received by that person may be taxable in South Africa if that person maintains a PE in South Africa, or if a dominant originating cause of the sales income is located in South Africa in accordance with the common law principles noted above.

Given the extensive DTT network South Africa has, and the discussion regarding the concept of a PE in 4.3, it is submitted that the taxation of software-related income accruing to tax residents of countries with which South Africa has concluded DTTs is severely hamstrung by the inadequacies of the current PE concept in relation to software arrangements.

4.4.2 Service transactions

True source of income

The common law principles for determining the source of income arising from services rendered are the same as those relating to sales transactions in that the originating and dominant cause of the income must be ascertained, as well as that cause's location, to establish the source of the income. In almost all cases however, the dominant originating cause of service income will be the actual services rendered and the location where the services are rendered will usually be the source of the income.[81]

In the context of software arrangements, the services rendered will depend on the nature of the software arrangement. The question is whether services can be rendered in South Africa despite there being no physical presence of the enterprise rendering the service in South Africa. The term "service" is defined in the Oxford English Dictionary ("service, n.", 2010) as *"the action of helping or doing work for someone".* A service is an action performed for the benefit of someone. It is submitted that actions can be performed by individuals or by machines. The 2014 OECD commentary (paragraph 10 to article 5) supports this view by acknowledging that automated actions performed by machines may give rise to a PE in a given jurisdiction. In the context of software arrangements, actions executed by software may thus constitute services even though the physical presence of individuals may not be present in a jurisdiction where those actions are executed. Furthermore, such actions can only be executed on a physical machine and it is submitted that the server hosting the software performing the actions will usually be the source of such income where the dominant originating cause of the income is the service rendered by the software.

This again causes potential problems where numerous servers may host portions of the software or where servers are frequently moved. It is submitted that the common law has also not kept pace with developments in the digital economy in this regard and that the common law principles applicable to service income are inappropriate in providing certainty as to the source of income in the context of the digital economy.

Deemed source of income

Service income in the context of software arrangements is likely to constitute business profits in terms of article 7 of the OECD Model Tax Convention. Consequently, tax residents of

[81] *Lever Brothers* case (supra); *M Ltd v COT* (1958) 22 SATC 27

countries with which South Africa has negotiated DTTs would only be subject to tax in South Africa in respect of such profits if they maintained a PE in South Africa. Thus the discussion regarding the concept of a PE for South African tax purposes as referred to above applies *mutatis mutandi* to services rendered in the context of software arrangements.

However, where the recipient is not a resident of a country with which South Africa has a DTT, service income in the context of software arrangements may be taxable in South Africa if that person maintains a PE in South Africa, or if a dominant originating cause of the service income is located in South Africa in accordance with the common law principles noted above.

4.4.3 Lease transactions

True source of income

The courts have held that, in the case of leases of movable property for long duration which specify the place where the movable property is to be used, the place at which the movable property is situated constitutes the source of the rental income. The position would be otherwise with the letting of smaller things for a short period. In such a case the source would probably be the location of the profit-producing activities.[82]

In the context of software arrangements, if a component of a software arrangement relates to the lease of software, the above case law principles will find application and it is likely the location of the profit-producing activities of the lessor will constitute the source of the income (given that software is likely to be leased for relatively short periods). Where a physical object is leased (such as space on a hard-drive), the above case law principles will also find application.

It is submitted that the case law principles applicable to leasing are relatively straight-forward and still find application in the current digital economy, unlike the principles applicable to sales and service transactions.

Deemed source of income

As rental income in the context of software arrangements is unlikely to arise in respect of the use of immovable property, such income would therefore fall within the ambit of the business profits classification in the OECD Model Tax Convention. Consequently, tax residents of countries with which South Africa has negotiated DTTs would only be subject to tax in South

[82] *COT v British United Shoe Machinery SA Pty Ltd* (1964) 26 SATC 163

Africa in respect of such income if they maintained a PE in South Africa. Thus the discussion regarding the concept of a PE for South African tax purposes as referred to above applies *mutatis mutandi* to rental income in the context of software arrangements.

However, where the recipient is not a resident of a country with which South Africa has a DTT, rental income in the context of software arrangements may be taxable in South Africa if that person maintains a PE in South Africa or if a dominant originating cause of the rental income is located in South Africa in accordance with the common law principles noted above.

4.4.4 Royalties

True source of income

As discussed in chapter 3, royalties are frequently prevalent in the context of software arrangements. In the case of *Millin v Commissioner for Inland Revenue*[83], the court considered the source of royalties received by a novelist to be the employment of her faculties within South Africa in writing the novels and in making contracts for publication with her publishers. It is submitted that the principle derived from this case applies equally to royalties from IP as defined in section 23I of the ITA in cases where the royalties are received by the person who is the original creator of the work (De Koker & Williams, 2015).[84]

Where the person who derives royalties is not the original author or inventor, the originating cause of the income would not be the employment of the *"wits, labour and intellect"* of the recipient, but rather the ownership of the copyright, trademark, design or patent. In such cases, the originating cause of the income may be the business of the person owning the rights, the capital employed to acquire the rights, the use of the rights in question or the agreement giving rise to the royalties. Each situation would have to be considered on its own merits (De Koker & Williams, 2015).

Deemed source of income

Despite the common law principles set out above, section 9(2) of the ITA practically renders such principles redundant in that it sets out that royalties incurred by South African residents, as well as royalties in respect of which IP (as defined in section 23I) is used in South Africa,

[83] (1928) 3 SATC 170

[84] De Koker, D.P. & Williams, R.C. 2015. *Silke on South African Income Tax.* [Lexis Nexis]. Available: http://www.mylexisnexis.co.za/Index.aspx [2015, November 15].

are deemed to arise from a source within South Africa. The only situations where the true source of royalties may arise in South Africa and the deemed source may not be South Africa, relate to situations where non-residents pay royalties to fellow non-residents in respect of IP not used in South Africa. Such situations are impractical to consider for taxing purposes, as no tax presence in respect of either the payer or the recipient may be present in South Africa.

As discussed in chapter 1, section 9(2) specifically sets out when a royalty or like payment is deemed to be income from a source within South Africa in relation to IP.

The requirements in paragraphs (c) and (e)[85] of section 9(2) are relatively straight forward and do not pose any problems from an interpretational perspective as the concepts of what constitutes a royalty and what constitutes know-how for the purposes of the ITA have been analysed extensively in chapter 3. In addition, it is clear that the requirements of these paragraphs require the amounts to be incurred by South African tax residents.

Paragraphs (d) and (f) however refer to the fact that royalties and know-how need not necessarily be incurred by South African tax residents to be deemed to be from a source in South Africa. Rather, these paragraphs require that the payments relate to the use of IP or know-how in South Africa. The crucial aspect to consider in the context of software arrangements is the determination of when copyright subsisting in software and any related know-how would be deemed to be used in South Africa.

The term "use" is defined in the Oxford English Dictionary ("use, v.", 2010) as *"take, hold, or deploy (something) as a means of accomplishing or achieving something; employ"*. It is clear that the common English understanding of the word was borne in mind in the wording of the legislation in section 9(2) of the ITA. From the dictionary meaning of the word it is evident

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[85] As set out in chapter 1, section 9(2) states that: "*An amount is received by or accrues to a person from a source within the Republic if that amount—…*

c) constitutes a royalty that is attributable to an amount incurred by a person that is a resident, unless that royalty is attributable to a permanent establishment which is situated outside the Republic;

d) constitutes a royalty that is received or accrues in respect of the use or right of use of or permission to use in the Republic any intellectual property as defined in section 23I;

e) is attributable to an amount incurred by a person that is a resident and is received or accrues in respect of the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render, any assistance or service in connection with the application or utilisation of such knowledge or information, unless the amount so received or accrued is attributable to a permanent establishment which is situated outside the Republic;

f) is received or accrues in respect of 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;"

that for IP or know-how to be used in South Africa, such property must be employed in South Africa to achieve a goal. From the analysis of copyright in chapter 2, copyright can only be exploited for a given purpose where the item subject to copyright is reproduced legally in terms of the copyright. Consequently, it is submitted that copyright will only be deemed to be used in South Africa where the copyrighted article (being the software code) is reproduced in South Africa in terms of the copyright held by the reproducer. Where the reproduction does not constitute the use of a copyright, such as the instances noted in section 19B of the Copyright Act, such reproduction would fall outside the ambit of section 9(2) of the ITA. Similarly, where know-how is employed in South Africa by the recipient of the know-how to achieve an objective, such know-how will be deemed to be used in South Africa. It is submitted that know-how will be employed in South Africa where the know-how results in some efficiency or benefit occurring in South Africa (e.g. in relation to a process efficiency etc.).

It must be noted however that royalties deemed to arise from a source in South Africa in terms of section 9(2)(c), (d), (e) and (f) of the ITA are subject to a final withholding tax in terms of section 49B of the ITA. Also, any royalty income received by a non-resident which has been subjected to this withholding tax is deemed to be exempt from income tax in terms of section 10(1)(l) of the ITA, unless the following exceptions apply:

1. the IP giving rise to the royalty is attributable to a PE in South Africa; or
2. in the case of the non-resident recipient being a natural person, that person was physically present in South Africa for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the amount was received by or had accrued to that person.

In these cases, the income attributable to the PE in South Africa or to the natural person recipient will be subject to income tax and not the withholding tax, as section 49D of the ITA exempts such income from the withholding tax on royalties. The practical effect of this is that royalty income arising from a deemed source in South Africa will never be subject to income tax in South Africa, but will only be subject to the final withholding tax (currently 15% of the gross royalty paid) noted in section 49B, except in the circumstances noted above.

Given that section 9(2) effectively renders the common law principles applicable to the source of royalties redundant and that it also effectively provides clarification on the determination of when royalties are deemed to arise from a source in South Africa, it is considered that the source rules applicable to royalties are still appropriate in the context of the digital economy.

4.5 CONCLUSION

This chapter concluded that there is a theoretical justification for taxing income arising from software-related arrangements in South Africa where the income arising in such arrangements can be linked to South Africa, based on whether at least some of the originating causes of the income are located in South Africa or based on the market or services South Africa provides to facilitate such arrangements.

Furthermore, it was established that in respect of countries with which South Africa has concluded DTTs, the income categories within which income arising from software arrangements may fall consist broadly of business profits and royalties. In the case of business profit income, the ability of South Africa to tax such income is severely limited by the current concept of a PE defined in the OECD Model Tax Convention. The concept of a PE is submitted to be outdated and inappropriate to facilitate the taxation of income arising from software arrangements. Income which may be justifiably taxable in terms of the sourcing and benefit theories may not be taxed due to the implementation of the fixed presence requirement of the PE concept.

As concerns royalty income accruing to residents of the above countries however, the chapter concluded that the current source rules in section 9(2) of the ITA are appropriate in that they provide certainty on the source of such income and also enable South Africa to tax income arising in South Africa in line with the benefit and sourcing theories.

In respect of countries with which South Africa does not have DTTs, this chapter concluded that in respect of sales and service income, the current common law principles applicable are outdated and inappropriate and that it may be necessary to legislate provisions in this regard to provide certainty in the context of the digital economy. In addition, the deemed source provisions in section 9(2) are similarly subject to the same PE limitations noted above.

However, in respect of lease and royalty income accruing to residents of countries noted in the above paragraph, this chapter concluded that the current source rules contained in the common law and the provisions of section 9(2) remained appropriate to provide certainty on the sourcing of such income, and also to enable South Africa to tax this income in line with the sourcing and benefit theories noted above.

CHAPTER 5: POSSIBLE RECOMMENDATIONS FOR THE TAXATION OF SOFTWARE ARRANGEMENTS IN SOUTH AFRICA

5.1 INTRODUCTION

Chapter 4 concluded that the current source rules implemented by South Africa are inadequate in relation to business income derived from services and the sale of goods in the context of software arrangements. In respect of countries with which South Africa has concluded DTTs, the inadequacy stems from the implementation of the PE concept which often results in income not being taxed in the source country despite significant links to the income existing in the source country. In respect of countries with which South Africa has not concluded DTTs, the source rules in relation to service income and sales income are unclear creating uncertainty in their application.

The purpose of this chapter is not to analyse potential solutions in detail, but to highlight possible solutions which may be researched further.

5.2 GENERAL RECOMMENDATIONS

In determining possible solutions to alleviate the shortfalls identified above, it is necessary that any potential solution comply with general international tax principles, namely, the so-called Ottawa principles.[86]The Ottawa principles are:

1) Neutrality: The same tax principles should apply to all businesses;
2) Efficiency: Taxes should be efficient to implement;
3) Certainty and simplicity: Taxes should be simple and easy to understand;
4) Effectiveness and fairness: Taxation should be effective and equitable; and
5) Flexibility: Taxes should be adaptable to new circumstances and developments (OECD, 2015:17)

Arguably, given that one of the main concerns arising for the taxation of income in the digital economy is the reduced need for physical presence by enterprises in source countries, one of the most important criteria for a possible solution should be its enforceability.

[86]OECD. 2015. *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris. Available: http://dx.doi.org/10.1787/9789264241046-en [2015, November 16]

To this end, given that it is likely to prove extremely challenging to force entities to register for income tax purposes in South Africa where they do not maintain a physical presence in the country, it is suggested that any possible solution should encourage registration by offering tax incentives to do so (e.g. such as taxation of income on a net basis as opposed to a gross basis).

It is also suggested that given South Africa's well developed bank and financial infrastructure, and the current implementation of exchange controls, that these elements be used to their full effect to aid in the enforceability of any solution. Given these considerations, the possible options to address the shortfalls identified in chapter 4 will be discussed further in the following paragraphs.

5.3 POSSIBLE SOLUTIONS RELATING TO COUNTRIES WITH WHICH SOUTH AFRICA HAS CONCLUDED DTTS

One of the possible ways South Africa could address the issue pertaining to the current shortfalls in the PE concept would be to renegotiate its treaty network, or at least the treaties with countries seen as key suppliers of software and digital services, with the incorporation of a new PE definition to cater for software arrangements. This could either be in the form of adding a deemed PE provision for software services and goods supplied, or the definition of a PE itself could be redrafted. This is in line with the OECD's Final Report on Addressing the Tax Challenges of the Digital Economy which notes that countries should be free to incorporate such changes into their respective treaties (OECD, 2015:13). It is also worth considering whether a withholding tax on income attributable to these so-called "digital PEs" could be incorporated into the ITA such as to facilitate the collection of income tax pertaining to the PEs.

Disadvantages of implementing the above would be the fact that compliance would still be difficult to enforce, given that the enterprises may not have a physical presence in South Africa, and the renegotiation of treaties may be difficult given that countries which generally export software-related goods and services are unlikely to be willing to accept such changes and are often economically powerful nations with enough political will to prevent such amendments. In addition, the attribution of profits to these PEs would have to be considered carefully.

Another possible solution is to implement a withholding tax at source that would fall outside the ambit of the DTT network. The obvious example is a Value-added Tax (VAT) on electronic services and goods relating to software arrangements. VAT is not a tax on income and thus not subject to the various DTTs South Africa has concluded, and it may be possible to levy VAT

on services and goods arising from software arrangements resulting in additional revenue for the South African tax authorities. The problem with this is that such a tax would arguably be borne by consumers in South Africa and not the enterprise supplying the goods or rendering the services. There are counterarguments to this as discussed below. In addition, there are also practical questions as to the implementation of such a VAT and what collection and registration mechanisms may be most effective.

Still, it is a potential option which avoids having to amend all the relevant DTTs South Africa has concluded. These options will now be discussed in further detail below.

5.3.1 Implementation of the digital PE concept

Hongler & Pistone (2015: 3-4) suggest that any potential new PE nexus relating to the digital economy should incorporate the following elements:

1) Digital services;
2) User threshold;
3) A certain time threshold; and
4) A *de minimis* revenue threshold.

Based on the above, Hongler & Pistone (2015: 3) propose the introduction of a new paragraph in article 5 to the OECD Model Tax Convention with the following wording:

> *"If an enterprise resident in one Contracting State provides access to (or offers) an electronic application, database, online market place or storage room or offers advertising services on a website or in an electronic application used by more than 1,000 individual users per month domiciled in the other Contracting State, such enterprise shall be deemed to have a permanent establishment in the other Contracting State if the total amount of revenue of the enterprise due to the aforementioned services in the other Contracting State exceeds XXX (EUR, USD, GBP, CNY, CHF, etc.) per annum."*

Hongler and Pistone (2015:42) propose the definition for a new PE nexus based on digital presence is appropriate as it complies with the various Ottawa principles as described below.

1) <u>Neutrality</u>

In its Final Report on Addressing the Tax Challenges of the Digital Economy, the OECD indicates that the "same principles of taxation should apply to all forms of business"

(2015:20). In other words the introduction of a new digital PE should not result in specific tax rules applicable only to such entities. Hongler and Pistone argue that a PE based on digital presence should not infringe on the neutrality principle as the concept would apply to all enterprises, not only specific companies (2015:41-42).

2) Efficiency

The introduction of a digital PE concept should also be efficient in that the associated administrative costs for affected enterprises should be minimal. This is on the basis that digital PEs would only be deemed to exist upon reaching a certain threshold indicative of significant presence (Hongler and Pistone, 2015:42). In this regard, it is worth investigating whether the implementation of a withholding tax in conjunction with the proposed digital PE definition could assist in the collection of income tax due. The considerations applicable to withholding taxes are discussed in 5.3.2 below.

3) Certainty and simplicity

Due to the fact that the digital economy is complex and ever-changing, it is accepted that any new solution will create ambiguities. However, on the basis that there seems to be a move towards the reallocation of income within the digital economy given the latest BEPS project, it should also be reasonable to accept that any new PE nexus will also create certain ambiguities (Hongler and Pistone, 2015:42). In any event, the current PE definition is also artificial in that it also represents a man-made threshold for determining taxing rights in a given jurisdiction (Hongler and Pistone, 2015:42).

4) Effectiveness and fairness

The proposed PE nexus should address the current inequality arising from the fact that source states are in many instances currently unable to tax income arguably being attributable to that jurisdiction as a result of the implementation of the current PE rules. The proposed digital PE concept would address this concern. In addition, the digital PE concept should be effective in raising revenue, especially if a withholding tax mechanism is incorporated with the digital PE concept.

5) Flexibility

It is clear that any rules or guidance applicable to the digital economy can become outdated very quickly. Any new PE definition should be flexible enough to accommodate likely future changes (Hongler and Pistone, 2015:43).

Hongler and Pistone (2015:42-43) argue that the proposed definition is in line with the Ottawa principles as discussed above and is also in line with the sourcing and benefit theories as described in chapter 4. It is submitted that such a proposal is a viable option, and if combined with a mechanism to assist in collecting income tax such as a withholding tax on electronic services and goods, such a solution may also prove to be effective.

The withholding tax could be implemented with the assistance of the banks and various payment agents located in South Africa who could monitor electronic payments exiting the country.

However, more analysis is required into the application of such a solution to ensure that it is indeed a viable option from a practical point of view, especially given the potential disadvantages discussed above.

5.3.2 Implementation of a VAT on digital transactions

Whilst a VAT on digital transactions would raise additional revenue, it does not address the problem of the supplying enterprise not being liable to income taxes in South Africa despite the related income arguably being "sourced" within South Africa. In this light, it is submitted that the VAT be used as an incentive measure to encourage suppliers to establish "digital PEs" in South Africa. Broadly speaking, this could be done by implementing a blanket VAT charge at a rate higher than the current 14% on all payments exiting the country flagged as for digital goods/services and these would be collected on behalf of the supplier by the respective payment agents.

The supplier would not have to register in South Africa for this charge to be effective as the consumer would effectively bear the cost and the amounts would be payable to SARS by the respective payment agent. A link between the VAT collected and the identity of the supplier would not need to be known to the South African tax authorities, provided VAT on all digital transactions is collected by the various payment agents. However, economically, this would have an impact on the supplier in the form of decreased sales or service income as the product would be more expensive. To encourage cheaper products, foreign suppliers could be

incentivised to establish local PEs in South Africa which meet the current PE requirements and which would be liable to income tax in South Africa on the attributable profit of such transactions. If enterprises established PEs, it would be possible to link specific bank account(s) with that entity and apply a reduced rate of VAT in respect of entities who register these PEs.

Such a solution will result in increased revenues and also result in such enterprises establishing PEs in South Africa which would result in these enterprises being subject to tax on income in South Africa. The solution would also facilitate the enforcement of the collection of income taxes and also potentially stimulate associated economic activity in South Africa. An analysis of the above in terms of the Ottawa principles indicates the following:

1) Neutrality

Similarly as discussed above, the application of the VAT would apply to all enterprises and not only to specific companies. However, such enterprises would be affected by the VAT only with regard to digital services and goods. Although it is noted that the VAT may encourage enterprises to establish a taxable presence in South Africa, this should not negatively impact neutrality. Rather, it would improve neutrality as businesses are currently discouraged from operating in South Africa due to the fact that such businesses are often not liable to tax in South Africa (despite them arguably sourcing their income in South Africa) due to them not having a physical presence in South Africa.

2) Efficiency

The implementation of the VAT should also be efficient in the sense that compliance costs should be minimal. Capabilities to monitor payments exiting the country already exist given South Africa's advanced banking system and the current implementation of exchange control regulations.

3) Certainty and simplicity

The VAT would be relatively simple to implement and if the affected transactions are defined properly, would achieve certainty as well.

4) Effectiveness and fairness

The implementation of a VAT would be effective as described above and would result in foreign enterprises supplying digital goods and services to customers in South Africa effectively being taxed in South Africa, thereby complying with the benefit and sourcing

theories discussed in this dissertation. In addition, these foreign suppliers would be placed on a level-playing field with local suppliers who are usually liable to VAT in South Africa on such supplies.

5) Flexibility

The VAT should be flexible so that the list of transactions covered, and the applicable rate, may be changed regularly to adapt to changes in the digital economy.

Given the above, it is submitted that the implementation of such a VAT is a viable option to address the current shortfalls in South Africa's sourcing rules pertaining to countries with which South Africa has concluded DTTs. However, as noted with the proposed implementation of a new digital PE, more analysis would be required as to the exact consequences and practical requirements of the implementation of such a VAT.

5.4 POSSIBLE SOLUTIONS RELATING TO COUNTRIES WITH WHICH SOUTH AFRICA HAS NOT CONCLUDED DTTS

As noted above in respect of countries with which South Africa has not concluded DTTs, it is recommended that certain legislative provisions be enacted so as to provide more certainty as to the application of the source rules in respect of business income arising from software arrangements.

In this regard, it is submitted that definitions for "digital goods and services" and "digital PE" be inserted in the ITA. Section 9 of the ITA should be amended to include a provision deeming income arising from digital goods and services and attributable to a digital PE to be derived from a source in South Africa. This would ensure that income relating to goods and services supplied or rendered in the context of software arrangements would be caught within the South African tax net if the income bore a close enough relationship to a source in South Africa. The proposed definition of a digital PE as discussed in 5.3 could be used as a basis for such a definition. In addition, the provision could state that the income derived from the sale of such goods or the rendering of such services would only be subject to tax in South Africa if it was derived by a digital PE thus rendering the common law provisions in respect of such transactions irrelevant.

Again, a disadvantage of implementing the above is that the enforcement of the collection of the income tax would be difficult to implement.

Similarly to the suggestions in 5.3, VAT could be levied on such transactions which could be reduced where the enterprise maintains a PE in South Africa so as to encourage the establishment of PEs to assist in the enforcement of the collection of taxes. Alternatively, a withholding tax on digital services could be implemented as noted in 5.3 to assist with the collection of income tax.

5.5 CONCLUSION

This chapter concluded that despite the current shortfalls in South Africa's source rules pertaining to transactions applicable to software arrangements, there are potential solutions to these shortfalls, each with their own advantages and disadvantages. The proposed solutions broadly comprise the following.

In relation to countries with which South Africa has concluded DTTs:

1) The insertion of a definition of a digital PE in DTTs with countries who export software services or digital goods to South Africa; or
2) The implementation of a VAT on the above services or goods rendered by non-resident enterprises in such a manner to encourage the establishment of PEs in South Africa to take advantage of a reduced VAT rate.

The chapter concluded that both options are viable in terms of the Ottawa principles, but it is likely that the implementation of a VAT may be the most effective option given the likelihood that South Africa may not be that successful in renegotiating DTTs with powerful software-exporting countries. Whilst these options may be viable, more analysis is required to determine the exact practicalities and consequences of their implementation.

In relation to countries with which South Africa has not concluded DTTs, it is recommended that section 9 of the ITA incorporate definitions for "digital goods and services" and "digital PE" and that the section provide for income arising from such transactions and attributable to such PEs to be deemed to arise from a source in South Africa. These provisions should ideally be incorporated with the recommendations noted above relating to countries with which South Africa has concluded DTTs to ensure their effectiveness.

CHAPTER 6: CONCLUSION

6.1 INTRODUCTION

In recent decades, the rise of the digital economy has drastically changed the way the world does business. Business can now be conducted without regard to geographical boundaries and limitations and organisations have the ability to conduct business making use of mobile and sophisticated software in South Africa without having a significant physical presence in the country. In addition, the characterisation of income from new software-related arrangements may be difficult to determine in this new economy. Increased computing power now allows for certain business activities to be carried out automatically by advanced software. Despite the above, it is submitted that the same business principles of old still apply in the digital economy, it is however the manner in which business is now conducted which has changed.

In response to the above developments, there is a general move globally to align taxation with economic substance and value creation and there is an increased focus on source-based taxation.

Consequently, an analysis of the relevance and appropriateness of South Africa's source rules pertaining to software arrangements as contained in section 9 of the ITA and as espoused in the common law constituted the main thrust of this dissertation.

6.2 PROCESSION OF DISSERTATION

As a basis for evaluating the source rules applicable to software arrangements in South African tax law, chapter 2 of this dissertation analysed the concepts of software and copyright for South African tax purposes. Software, digital content and copyright are all inter-related. It is vital to understand the interaction between software and copyright in order to determine the true nature of payments made in respect of various business arrangements incorporating software.

Chapter 2 concluded that although copyright usually subsists in software and it will usually be the case that the use of software will result in the use of a copyright, given the inherent nature of the operation of software, this is not always the case. In terms of South African copyright law it can be argued that copies made of a computer program to facilitate the effective operation thereof do not constitute the use of a copyright. Payments made in such arrangements would arguably not be made for the use of a copyright and thus would not constitute royalties for the purposes of the ITA.

Chapter 3 attempted to broadly distinguish the main income characterisations (sales, service arrangements, leases and royalties arrangements) relevant in the context of software arrangements for the purposes of forming a foundation to evaluate the current source rules applicable to software arrangements contained in section 9 of the ITA and as espoused in the common law.

In addition, the meaning of the term "royalty" was considered for South African tax purposes and for the purposes of the OECD Model Tax Convention and it is submitted that with the exception of show-how as espoused in section 49A of the ITA, the concepts of a royalty and know-how are consistent in the OECD Model Tax Convention and the ITA.

Specifically in relation to software arrangements, a distinction should be made between the copyrighted article and the copyright itself. Payments made for both elements should be evaluated separately and where a combination of elements are present in an arrangement, the associated payment should be apportioned into its various components, unless one of the components is clearly insignificant, in which case that component should be disregarded for characterisation purposes.

In chapter 4, an evaluation of the tax source rules applicable to software arrangements in South Africa was conducted. This chapter concluded that there is a theoretical justification for taxing income arising from software-related arrangements in South Africa where the income arising in such arrangements can be linked to South Africa based on whether at least some of the originating causes of the income are located in South Africa or based on the market or services South Africa provides to facilitate such arrangements.

Furthermore, it was established that in respect of countries with which South Africa has concluded DTTs, the income categories within which income arising from software arrangements may fall consist broadly of business profits and royalties. In the case of business profit income, the ability of South Africa to tax such income is severely limited by the current concept of a PE defined in the OECD Model Tax Convention. The concept of a PE is submitted to be outdated and inappropriate to facilitate the taxation of income arising from software arrangements. Income which may be justifiably taxable in terms of the sourcing and benefit theories may not be taxed due to the implementation of the fixed presence requirement of the PE concept.

As concerns royalty income accruing to residents of the above countries however, the chapter concluded that the current source rules in section 9(2) of the ITA are appropriate in that they

provide certainty on the source of such income and also enable South Africa to tax income arising in South Africa in line with the benefit and sourcing theories.

In respect of countries with which South Africa does not have DTTs, chapter 4 concluded that in respect of sales and service income, the current common law principles applicable are outdated and inappropriate and that it may be necessary to legislate provisions in this regard to provide certainty in the context of the digital economy. In addition, the deemed source provisions in section 9(2) are similarly subject to the same PE limitations noted above.

However, in respect of lease and royalty income accruing to residents of countries noted in the above paragraph, chapter 4 concluded that the current source rules contained in the common law and the provisions of section 9(2) remained appropriate to provide certainty on the sourcing of such income and also to enable South Africa to tax this income in line with the sourcing and benefit theories noted above.

Lastly, chapter 5 contained a discussion on the potential solutions to address the current inadequacies in South Africa's source rules pertaining to software arrangements. The proposed solutions broadly comprise the following.

In relation to countries with which South Africa has concluded DTTs:

3) The insertion of a definition for "digital PE" in DTTs with countries who export software services or digital goods to South Africa; or
4) The implementation of a VAT on the above services or goods rendered by non-resident enterprises in such a manner to encourage the establishment of PEs in South Africa to take advantage of a reduced VAT rate.

The chapter concluded that both options are possible to implement and would likely achieve the desired outcomes, but it is likely that the implementation of a VAT may be the most effective option given the likelihood that South Africa may not be that successful in renegotiating DTTs with powerful software-exporting countries. Whilst these options appear to be viable, more analysis is required to determine the exact practicalities of their implementation.

In relation to countries with which South Africa has not concluded DTTs, it is recommended that section 9 of the ITA incorporate definitions for "digital goods and services" and "digital PE" and that the section provide for income arising from such transactions and attributable to

such PEs to be deemed to arise from a source in South Africa. These provisions should ideally be incorporated with the recommendations noted relating to countries with which South Africa has concluded DTTs to ensure their effectiveness.

6.3 CONCLUSION

The previous chapters have analysed the characterisation of income relating to software arrangements for the purposes of South African tax law and have also evaluated the tax source rules applicable to these arrangements. The dissertation has concluded that the current source rules as contained in section 9 of the ITA and the common law are inadequate in relation to these arrangements pertaining to sales and service income. However, there are potential solutions to these challenges, but the various solutions identified in this dissertation should be investigated further to determine their practicability, weighing up the respective potential advantages and disadvantages. Clearly the issue of source-based taxation is a difficult topic politically, as evidenced by the current BEPS project initiated by the G20, and it is submitted that political considerations may be the most influential factor in determining any potential solution.

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