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Dear Sirs

Section 9D(9)(b)(iii) – Exclusion to the business establishment exemption for active royalty income

The purpose of this letter is to make certain representations on the abovementioned provision of the Income Tax Act of 1962 (as amended) ("the Act") to National Treasury to the effect that active royalty income should be excluded from imputation in terms of South Africa's Controlled Foreign Company ("CFC") legislation. The aim of our representations is to show that our proposed changes follow established international best practice and the treatment of similar income items in section 9D.

To highlight the concern, we set out an illustrative case study to show the inherent shortcomings contained in the current CFC legislation and would comment that we have identified that this issue is of wide application, existing wherever Research and Development is actively developed to market to third parties.

1 Illustrative case study

1.1 A South African incorporated company ("SA Co") is part of a multinational group.

1.2 The SA Group has significant operations located offshore, where it generates revenues purchasing and developing and then licencing out computer software.

1.3 The group structure is as set out in Appendix A.

1.4 One of the CFC's develops intellectual property ("IP") (e.g. technology patents, designs, copyright, etc.) and leases the IP at an arms length price to other group companies and non-connected third parties. The income so earned is therefore not of a passive nature but rather as a result of this CFC's active conduct of business.

1.5 When these active royalties accrue to this CFC from third parties (or related parties which are not CFC's in relation to the same resident), this income is imputed into the taxable income of the SA parent company on the basis that none of the exemptions to the CFC rules apply as all types of royalties are considered to be imputable passive income.

1.6 The problem identified is that the South African CFC rules relating to the imputation of active royalties earned by CFC's are not in line with the mischief sought to be repressed by these rules nor is it in line with international best practice. This may result in SA resident groups not being able to compete within offshore markets against groups from other countries that do not currently tax such active royalty income in the hands of their resident shareholders.

1.7 Accordingly we request that the business establishment exemption, within section 9D, be amended to include the carrying on of an "active royalty business" and as a result exempt income arising from these businesses from being immediately taxed in South Africa. As will be illustrated below our request is based on international best practice as reflected in the CFC legislation of South Africa's main trading partners as well as the reasoning underlying section 9D and the treatment of similar income in section 9D.

1.8 We set out our viewpoint below.

2 Proposed recognition of the 'active royalty' concept

2.1 We provide extracts of the SA tax legislation pertinent to these representations in Appendix B.

2.2 Our representations are based on the following:

a) National Treasury's detailed explanation to section 9D of the Income Tax Act;
b) The Fifth Report of the Katz Commission;
c) International best practice, including the CFC regimes of certain of South Africa's main trading partners;
d) Treatment of similar income in section 9D, e.g. rental income.

National Treasury's explanation to section 9D

2.3 Section 9D was introduced to prevent the avoidance of taxation on investment income[1] through the use of foreign companies by South African residents.

[1] Investment income was defined in section 9C(1) as 'any income in the form of any annuity interest, rental income or royalty or any income of a similar nature'.

2.4 The introduction of the residence basis of tax in 2001 led to substantial changes in the CFC rules. With these amendments a document entitled "National Treasury's Detailed explanation to section 9D of the Income Tax Act" authored by Prof. Keith Engel was published. This document indicates that the rationale for the amended CFC legislation was essentially to prevent deferral of taxation on income through South African owned foreign entities.

2.5 From the following extract, it is apparent that the policy considerations underscoring section 9D seek to establish a fair balance between the principles of anti-deferral and international competitiveness:

> "The principles of anti-deferral and international competitiveness are diametrically opposed. Anti-deferral warrants complete taxation, whereas international competitiveness warrants complete exemption. In the end, section 9D follows international norms favouring a balanced approach. Section 9D achieves this balance by favouring international competitiveness (i.e., exemption) where the income stems from active operations. Anti-deferral (i.e., immediate taxation) applies where the income stems from passive investments or from transactions that meet objective criteria with a high tax avoidance risk."[2]
>
> "Passive income and gains are fully subject to tax because no direct competitiveness concerns are at stake if no active business is involved."[3]
>
> (Our underlining added)

2.6 We consider that if it was Treasury's intention to favour international competitiveness in circumstances where income stems from active business (as stated above), then surely all income from active operations should be exempt from attribution under the CFC rules, notwithstanding the fact that it is labelled as a potentially passive income item. As the immediate taxation of royalty income arising from active business operations impacts international competitive considerations for South Africa, our view – which is in agreement with the principles stated in the above extract – is that such royalty income should be exempt from current taxation in South Africa.

2.7 The second part of the above extract implies that section 9D will only impute passive income in circumstances where there is no active business, whereas presently the CFC rules actually impute more than this. We consider that the tax policy in respect of CFCs as set out in the above extract is therefore not accurately reflected in the provisions of section 9 D, which should be amended to achieve the required balance.

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[2] Engel, K. *National Treasury's Detailed Explanation to Section 9D of the Income Tax Act*, 2002 at 2.

[3] Engel *supra* at 17.

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Fifth Report of the Katz Commission

2.8 In the Fifth Report of the Katz Commission[4], it was recommended that the definition of active income be based on international norms when the following was said at 3.2.4:

> "In defining what "active" income is, international norms should be used, plus some degree of specific definition. Passive income will be all income which is not active income."

2.9 As a result of the above recommendation, we have researched international norms and provide below comparative CFC legislation[5] for the United States of America, Canada and the United Kingdom.

Comparative CFC legislation

United States of America

2.10 Our understanding is that in terms of subpart F of the USA Internal Revenue Code ("the Code"), certain U.S. shareholders (U.S. persons who own 10 percent or more of the voting stock) of CFC's are taxed on certain types of income earned by CFCs. CFCs are foreign corporations of which more than 50 percent of the stock by vote or value is owned by U.S. shareholders.

2.11 The US does provide exemption from attribution of certain amounts from being immediately taxed in the U.S. More specifically section 954(c)(2)(A) of the Code provides that the following is excluded from attribution:

> "(A) Rents and royalties derived in active business
> Foreign personal holding company income shall not include rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person (within the meaning of subsection (d)(3))." [6]

Royalties from the active conduct of business and received from non-related persons are therefore commonly exempt from attribution under the Code which is broadly in line with international tax norms such as those encountered in, for example, Australia's CFC rules.

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[4] 5th Report of the Katz Commission, *Basing the South African Income Tax system on the Source or Residence principle – Options and recommendations.*

[5] Unless otherwise stated, the legislation was taken from the 5th Report of the Katz Commission and we have confirmed with the PwC offices in the specific countries that there has been no material changes to the legislation since the publication of 5th Report.

[6] US Code accessed on the 31st August 2005 at www.law.cornell.edu/uscode.

2.12 We provide the applicable tax provisions of the US Internal Revenue Code as Appendix C.

Canada

2.13 Canadian tax law is similar in effect to that of the USA in so far as the exclusion of active royalties from CFC imputation is concerned. Passive income streams are considered active and not imputed if the company receiving the income meets certain tests, which include:

a) more than 5 employees are employed by the company;

b) the carrying on of a certain type of business including IP businesses; and

c) if the CFC's business is carried on principally with persons at arm's length.[7]

United Kingdom

2.14 We understand that based on the case of the Earl of Howe[8] (concerning the deductibility of certain costs), the Court[9] identified different types of income, distinguishing between 'pure profit', passive, type income (which at the time were subject to a withholding by the payer) and 'active' income whereby the amounts received do not constitute only profit, but involve also some underlying service or cost, i.e. a business.

Treatment of similar income in section 9D

2.15 In terms of section 9D(9)(b)(iii)(bb) passive income items similar to royalties are not imputed where they arise from the particular CFC's principal trading activities.

2.16 For these purposes passive income includes dividends, interest, royalties and rental income. However, Treasury has recognised that certain income streams labelled as passive income items are in fact income from active operations such as those carried on by banks, insurers, rental companies, etc. In this regard we refer you to the following extract from Prof. Engel's note on section 9D *supra* at 19:

> "Passive income may alternatively be exempt from section 9D if that passive income arises from the principal trading activities of a bank, financial services, insurance, or rental business. The purpose of the principal trading activity requirement is to ensure that a CFE is not merely a finance or a treasury operation with a better label designed to avoid section 9D. CFEs also cannot

[7] Income Tax Act, R.S.C. 1985, c. 1 (5th Supp.) accessed on the 31st August 2005 at http://laws.justice.gc.ca/en/I-3.3/index.html.

[8] *Earl Rowe v Inland Revenue Commissioners* [1916-19] All ER Rep 1088.

[9] See judgement of Scrotton LJ

shelter portfolio passive investments under this rule to the extent the passive income stems from portfolio investments unrelated to the principal trading activity of the business. While passive income is normally incidental to a business, passive income of this kind represents core business activities, thereby re-raising the spectre of international competitiveness. However, no exemption of this kind exists for royalties or other income from the use of intangibles due to anti avoidance concerns. The distinction between an active royalty business and series of passive streams is simply too amorphous."

(Our underlining added)

2.17 From the above statement, it appears that the main reason why royalties from active operations were not exempt from attribution under section 9D was as a result of tax avoidance concerns. We believe that the distinction between active and passive royalties is in fact clear and very similar to items such as, for example, active interest income for a bank. On the basis that other countries have successfully implemented such tax provisions or recognise, as in the case of the UK, that income may come from different sources, we suggest that South Africa also does so. In other countries such as those discussed earlier, tax avoidance risks were reduced by legislating that only royalties received from third parties (who are not connected persons) are exempt from imputation.

2.18 The concept of a royalty is in essence a consideration received for the use of a certain type of capital asset, i.e. intellectual property. We therefore submit that a royalty is akin to rental income and accordingly these two income streams should be taxed on the same basis. Therefore, where royalties have arisen from the principal trading activity of a CFC, South Africa should exempt the SA shareholder from immediate taxation of such income similarly to the present exemption provided for a rental business carried on by a CFC.

3 Proposed section 9D amendments

3.1 We propose the following amendments to section 9D(9)(b)(iii)(bb) on the basis of the above representations (the suggested amendments are underlined):

"(bb) where those amounts arise from the principal trading activities of any banking or financial services, insurance, rental or royalty business, excluding any such amounts derived—

...

(D) by a royalty business from a connected person.

3.2 Further, our proposed amendments would appear to be wholly in line with certain other amendments proposed by SARS/Treasury, namely certain intangible assets which were purchased or developed outside South Africa and sold as part of a going

concern should also qualify for the business establishment exemption. This is set out in the latest "Draft Revenue Laws Amendment Bill Batch Three" at 13:

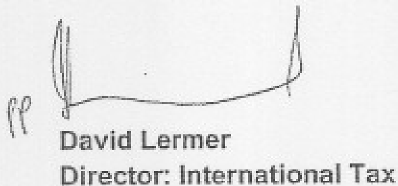
> "(k) by the addition in subsection (9) to subparagraph (11) of paragraph (b) of the following item:
> (cc) where the amounts arise from the disposal or deemed disposal of any intangible asset as defined in paragraph 16(2) of the Eighth schedule (other than an intangible asset created, devised or developed in the Republic) if that intangible asset was held by that controlled foreign entity for a period of at least 18 months prior to that disposal as an integral part of any business conducted by that controlled foreign company and was so disposed of as part of the disposal of that business as a going concern"

4 Conclusion

4.1 From the above it is clear that based on both a comparison of the treatment of similar income streams (e.g. active rental income of a CFC) in section 9D and the exemptions for active royalty income provided by certain of South Africa's main trade partners (USA, UK and Canada) there are convincing grounds that active royalty income should be excluded from imputation if arising in SA CFC's.

Should you have any questions regarding the above or any other matter, please do not hesitate to contact us.

Yours sincerely



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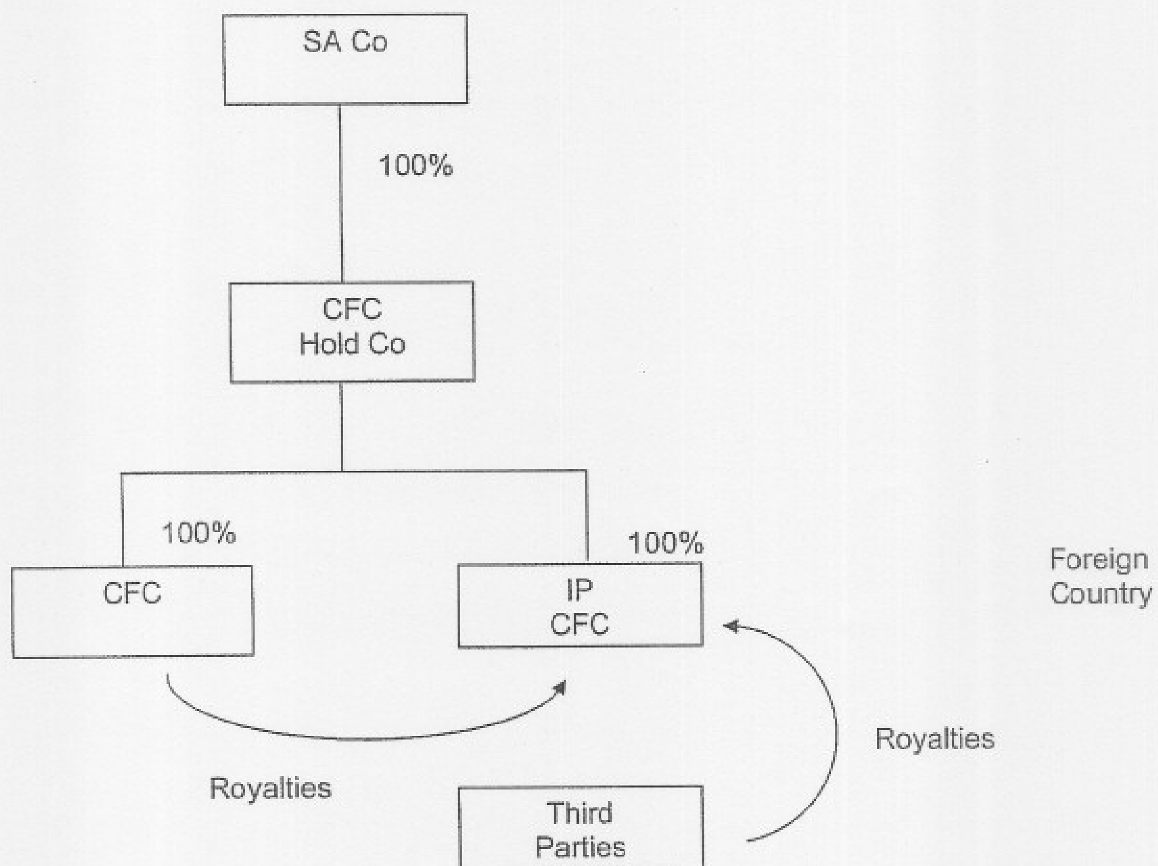
Appendix A



9D. Net income of controlled foreign companies.

...

(2) There shall be included in the income for the year of assessment of any resident who holds any participation rights in a controlled foreign company—

....

(9) The provisions of subsection (2) shall not apply to the extent that the net income of the controlled foreign company—

...

(b) is attributable to any business establishment of that controlled foreign company in any country other than the Republic: Provided that the provisions of this paragraph shall not apply to any net income that is attributable to—

.....

(iii) any amounts in the form of dividends, interest, royalties, rental, annuities, insurance premiums or income of a similar nature, or any capital gain determined in respect of the disposal of any asset from which any such amounts are or could be earned, or any foreign currency gain determined in respect of any foreign equity instrument or any foreign currency gain determined in terms of section 24I, except—

(aa) to the extent that any income and capital gains attributable to those amounts (other than income or capital gains in respect of which any of the provisions contained in paragraphs (e) to (fB) apply) do not in total exceed ten per cent of the income and capital gains of the controlled foreign company attributable to that business establishment other than income or capital gains—

(A) attributable to those amounts; or

(B) in respect of which any of the provisions contained in paragraphs (e) to (fB) apply; or

(bb) where those amounts arise from the principal trading activities of any banking or financial services, insurance or rental business, excluding any such amounts derived—

(A) by a company which is a foreign financial instrument holding company at the time that the amounts are so derived;

(B) from any connected person (in relation to that controlled foreign company) who is a resident or any resident who directly or indirectly holds at least five per cent of the participation rights in—

(i) that controlled foreign company; or

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(ii) any other company in the same group of companies which holds shares in that controlled foreign company; or

(C) to the extent that those amounts form part of any transaction, operation or scheme in terms of which any amount received by or accrued to any person is exempt from tax while any corresponding expenditure (other than expenditure for the delivery of any goods including electricity) is deductible by that person or by any connected person in relation to that person in determining the liability for tax of that person or connected person, as the case may be, in terms of this Act;

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"§ 952. Subpart F income defined **Appendix C**

(a) In general *For purposes of this subpart, the term "subpart F income" means, in the case of any controlled foreign corporation, the sum of—*

(1) ...,

(2) the foreign base company income (as determined under section 954),

§ 954. Foreign base company income

(a) Foreign base company income *For purposes of section 952 (a)(2), the term "foreign base company income" means for any taxable year the sum of—*

(1) the foreign personal holding company income for the taxable year (determined under subsection (c) and reduced as provided in subsection (b)(5)),

(2) ...

(b) Exclusion and special rules

(1) ...

(3) De minimis, etc., rules

For purposes of subsection (a) and section 953—

(A) De minimis rule *If the sum of foreign base company income (determined without regard to paragraph (5)) and the gross insurance income for the taxable year is less than the lesser of—*

(i) 5 percent of gross income, or

(ii) $1,000,000,

no part of the gross income for the taxable year shall be treated as foreign base company income or insurance income.

(c) Foreign personal holding company income

(1) In general

For purposes of subsection (a)(1), the term "foreign personal holding company income" means the portion of the gross income which consists of:

(A) Dividends, etc. *Dividends, interest, royalties, rents, and annuities.*

(B) ...

(2) Exception for certain amounts

(A) Rents and royalties derived in active business Foreign personal holding company income shall not include rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person (within the meaning of subsection (d)(3))."