

BINDING PRIVATE RULING: BPR 090

DATE: 20 September 2010

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

SECTION : SECTION 9D(10)(a)(iii)

**SUBJECT : ROYALTY INCOME ATTRIBUTABLE TO A FOREIGN
BUSINESS ESTABLISHMENT OF A CONTROLLED FOREIGN
COMPANY**

1. Summary

This ruling deals with the taxability of royalty income under the provisions of section 9D of the Act where such income is attributable to a foreign business establishment of a controlled foreign company and the possible relief under the provisions of section 9D(9) of the Act.

2. Relevant tax laws

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

In this ruling legislative references to sections are to sections of the Act applicable as at 1 January 2008 and unless the context indicates otherwise, any word or expression in this ruling bears the meaning ascribed to it in the Act.

This ruling has been requested under the provisions of section 9D(10)(a)(iii).

3. Parties to the transaction

The Applicant: A company that is a “resident” as defined in section 1 that has a participatory interest in a controlled foreign company

Company A: A controlled foreign company that was a resident of foreign country A prior to its deregistration

Company B: A controlled foreign company that is a resident of foreign country B with Company A as its holding company

4. Description of the transaction

- Section 9D(9) provides relief in respect of the attribution to a resident of a controlled foreign company's income by disregarding the amount attributable to a foreign business establishment of that controlled foreign company in which the resident holds participation rights, but this relief excludes passive income such as royalties.
- The Commissioner may, however, rule that the royalty income attributable to such a foreign business establishment will not be taxed if the controlled foreign company regularly and directly creates, develops, substantially upgrades or adds value to (or provides substantial support services in respect of) intangibles giving rise to those royalties.
- The Applicant acquired Company A, from an independent third party. At the time of the acquisition, Company A owned intangibles in respect of which it received a small amount of royalties. Company A also owned a subsidiary, Company B.
- The group (consisting of the Applicant, Company A and Company B), develops products for the world market by way of research programmes. The intellectual property interests in these products enjoy varying levels of protection around the world. These products are licensed to licensees who produce and also market these products. Royalties are payable to the licensees upon the sale of these products.
- Prior to the acquisition of Company A, Company A paid for and acquired intellectual property rights. These rights resulted from research conducted in foreign country B. Company A earned royalties from the sale of the products developed from that research and does not have a foreign business establishment of its own.
- The shares held by Company A in Company B were transferred to the Applicant and the intellectual property rights owned by Company A were transferred to Company B. The remaining assets in Company A were transferred to Company B, followed by the deregistration of Company A. The required approval by the South African Reserve Bank was obtained at the time.
- Company B, the research and developing company in foreign country B, was merged with the group's marketing company in foreign country B. The passive income of Company B is expected to be less than 10% of its income for the years ended after 2008.

- Company B is actively involved with research and development. It currently has five (5) research and development stations in foreign country B. Three (3) of these five (5) research stations directly and regularly substantially upgrades or adds value to the intangibles giving rise to the royalties. One of the three (3) research stations entered into a research and development agreement with the Applicant before the Applicant acquired the foreign group (of which Company A and Companies B form part of). The intangibles created or developed in terms of the last mentioned research and development agreement are owned by the Applicant. Some of the products developed in South Africa are also used by the last mentioned research station to create and develop new products.

5. Conditions and assumptions

This ruling is made subject to the conditions and assumptions that –

- each of the three research stations qualifies as a “foreign business establishment” as defined in section 9D(1); and
- royalties that are received or accrued will be taxable in South Africa to the extent that these royalties relate to intangibles developed in South Africa or owned by a South African resident or developed on its behalf.

6. Ruling

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

- The application of the provisions of section 9D(9)(b)(iii) will be disregarded under section 9D(10)(a)(iii) in respect of royalty income which were received by or accrued to Company B where Company B, through those three research stations, directly and regularly created, developed, substantially upgraded or added value to (or provides substantial support services in respect of) the intangibles that gave rise to those royalties.
- The application of the provisions of section 9D(9)(b)(iii) will not be disregarded under section 9D(10)(a)(iii) in respect of royalty income which were received by or accrued to Company A since no royalties were attributable to a foreign business establishment of Company A.

7. Period for which this ruling is valid

This binding private ruling is valid until 30 July 2013.

Issued by:

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