

**INCOME TAX DEDUCTIONS AVAILABLE TO TAXPAYERS
IN RESPECT OF PAYMENTS FOR INTELLECTUAL PROPERTY**

Mini dissertation by

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Submitted in partial fulfilment of the requirements for the degree

MAGISTER COMMERCII (TAXATION)

in the

FACULTY OF ECONOMIC AND MANAGEMENT SCIENCES

at the

UNIVERSITY OF PRETORIA

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SEPTEMBER 2010

ACKNOWLEDGEMENTS

I would like to thank the rock in my life, Johan, for all his support and love; without him this dissertation would not be possible. To my three babies – Seuna, Boeta and Tiekels: you made it so much easier.

Thank you to my mother and all the rest of my family and friends who were always thinking of me and supporting me.

Thank you also to Redge de Swardt and other colleagues for their support and ideas.

SUMMARY

INCOME TAX DEDUCTIONS AVAILABLE TO TAXPAYERS IN RESPECT OF PAYMENTS FOR INTELLECTUAL PROPERTY

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The purpose of this study was to investigate the various income tax deductions which may be available to taxpayers who make payments in respect of intellectual property. Taxpayers who use intellectual property (such as patents and trade marks) in their trade in the production of income, may obtain the right of such use in a number of different ways. The nature of the transaction granting the taxpayer the use of intellectual property items determines the tax treatment thereof. Taxpayers may be able to claim deductions for the cost of using these items in terms of specific income tax sections or in terms of the general deduction formula.

OPSOMMING

INKOMSTEBALSTINGAFTREKKINGS BESKIKBAAR AAN BELASTINGPLIGTIGES TEN OPSIGTE VAN BETALINGS VIR INTELLEKTUELE EIENDOM

deur

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Hierdie studie ondersoek die verskeie aftrekkings wat vir inkomstebelastingdoeleindes geëis kan word deur 'n belastingpligtige ten opsigte van betalings gemaak met betrekking tot intellektuele eiendom. Belastingpligtiges wat intellektuele eiendom (soos patente en handelsmerke) in hulle bedryf aanwend in die voortbrenging van inkomste, kan die reg van sodanige aanwending op verskillende maniere bekom. Die aard van die transaksie wat aan die belastingpligtige die reg van gebruik van intellektuele eiendoms items verleen, bepaal die belastinghantering daarvan. Belastingpligtiges kan moontlik die koste van gebruik van sodanige items ingevolge spesifieke artikels van die wet of die algemene aftrekkingsformule eis.

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CHAPTER 1

INTRODUCTION AND BACKGROUND

1.1 INTRODUCTION

It often happens that taxpayers incur considerable expenses in acquiring certain intellectual property rights. Intellectual property refers to intangible rights to the products of the human mind, for example trademarks and copyright. These rights award the taxpayer the opportunity to use them in a trade and to produce income. As the income generated by these rights could be taxed in terms of the Income Tax Act 58 of 1962 (referred to as the “Act”) the question arises as to whether the expenses incurred in acquiring the rights will be deductible. In this study all references to section numbers will refer to sections of the Act (unless otherwise indicated).

The taxpayer could develop these rights or purchase them from another person. If the taxpayer develops the intellectual property himself or herself, it has to be established whether the development costs are deductible for income tax purposes. If the rights are purchased from someone else, the question is whether the purchase price is deductible. It can also happen that a taxpayer merely uses the intellectual property rights owned by someone else in exchange for the payment of consideration, for example in the form of royalties or premiums. The question then is whether those payments for the use of the intellectual property rights are deductible.

Income tax deductions available to South African taxpayers are regulated mainly by sections 11 to 19 and 23 of the Act (De Koker, 2010:§7.1). Some of these sections allow for the deduction of specific items of expenditure or loss for tax purposes. If there is no specific deduction provided for in the Act for a certain item of expenditure, a deduction may be sought in terms of the so-called “general deduction formula” contained in section 11(a). Section 11(a) sets out the general requirements for an item of expenditure to be deductible (known as the “positive test”) as follows:

“[f]or the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived-

- a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature”.

Section 11(a) has to be read together with section 23, which stipulates which expenses may not be deducted (known as the “negative test”) (De Koker 2010:§7.3). In other words, even though an expense may meet the requirements of section 11(a) to be deducted for income tax purposes, the deduction thereof may be prohibited by section 23.

1.2 BACKGROUND

During the past ten years, several court cases have dealt with the deductibility of intellectual property payments for income tax purposes. Some of these cases have considered the deductibility of such payments in terms of section 11(a) and more specifically with the issue of whether such payments constitute expenses of a capital or non-capital nature. Other cases have dealt with the requirements for deduction of such payments in terms of specific sections of the Act.

These court cases have emphasized certain important principles to be considered when determining the deductibility of royalty and other similar payments. It is important to understand these principles and to be able to apply them to any circumstances where such payments occur. It is therefore also important to know the exact nature (legal and substance) of certain expenditure to determine the tax treatment thereof.

In a Cape Tax Court case, *ITC 1798* (68 SATC 9) it was held that royalty payments made by a taxpayer were of a capital nature and therefore not deductible in terms of the general deduction formula. The taxpayer (BP Southern Africa) made royalty payments to its British parent company for the use of the parent’s trademark and licensed marketing symbols. The payments for the 1997, 1998 and 1999 years of assessment were disallowed as deductions by the South African Revenue Service (“SARS”).

In the subsequent Supreme Court of Appeal ruling *BP Southern Africa (Pty) Ltd v The Commissioner for SARS*, 2007 SCA 7 (RSA) (69 SATC 79), (referred to hereafter as “the BPSA case”) the decision was overturned and it was decided that the payments were not of a capital nature. This judgment is the one which will support the taxpayer’s contention that their royalty payments should be deductible. However, it was made clear in the Supreme Court of Appeal judgment that royalty payments will not automatically be of a

non-capital nature. The facts and circumstances of each case will have to be considered, as indicated by Ponnann JA in the *BPSA* case, namely that:

“[t]he conclusion to be drawn from all the cases seems to be that the true nature of each transaction must be examined in order to determine whether the expenditure in question is capital or revenue expenditure... In deciding that question each case must be decided on its own facts and circumstances.”

The judgment handed down in the *BPSA* case is in contrast with the one handed down in *C:SARS v Kajadas Cosmetics (Pty) Ltd*, 2002 (4) SA 709 (T) (64 SATC 200), in which it was held that payments made for exclusive distribution rights are of a capital nature. It is important to note that the facts of this case are substantially different from the above ones.

Depending on the circumstances, it may be concluded that a taxpayer made a payment to become the holder of certain intellectual property rights which will, in most cases lead to expenditure of a capital nature. It may, however, be that the taxpayer merely made payments for the right to use such intellectual property (such as royalties or licence fees), which in most cases will mean that the expenditure is not of a capital nature.

In *ITC 1726* (64 SATC 236) it was held that initial cellular license fees paid by a taxpayer did not meet the requirements of section 11(gA) because they could not be regarded as “property of a similar nature”. Although section 11(gA) has subsequently been replaced by section 11(gC) the decision reached in this case is still relevant, as section 11(gC) also refers to “property of a similar nature”. This case also considered whether such initial license fees would be deductible in terms of section 11(a). It was held that these fees were of a capital nature as they established an income-producing structure for the taxpayer. In this case the taxpayer also had to pay annual license renewal fees. These fees were held to be of a non-capital nature and deductible in terms of section 11(a).

In *C:SARS v SA Silicone Products (Pty) Ltd*, 2004 (66 SATC 131 (SCA)) the meaning of “property of a similar nature” was again considered (this time in the context of section 11(gC)) and held to refer only to property which is the result of an intellectual process.

In *ITC 1838* (72 SATC 6) it was decided that the valuation of trade marks was not required in order for the taxpayer to claim a deduction in respect of section 11(gA), since the

section referred to “expenditure actually incurred” and not to the value of the trade marks. Although the replacement section 11(gC) no longer allows for the deduction of trade marks, the decision in this case could have an impact on the deduction of the part of a business’ purchase price which relates to other types of intellectual property.

It is therefore important to study the mentioned court cases as well as related other cases to know what the differences were between them and how they apply to any relevant taxpayer’s situation when deciding whether payments for intellectual property rights are tax deductible.

Furthermore, during this period there have also been various changes to certain sections of the Act that deal with intellectual property.

All of these changes need to be taken into account to gain a full understanding of the current tax treatment of payments made for intellectual property. This knowledge should also be taken into account when drafting any contract providing for the payment of royalties or similar amounts.

1.3 PROBLEM STATEMENT

Payments are often made by taxpayers in respect of certain intellectual property items, such as patents, trademarks, copyrights and other similar items.

The Act provides for certain specific deductions that may be applicable to payments made in respect of intellectual property. These specific deductions apply, however, only in limited cases and only if specific requirements are complied with. A question arises as to the exact scope of these specific deductions and further whether such payments will qualify for a deduction in terms of section 11(a) in the event that the specific deductions are not applicable.

Due to recent court judgments and changes to the Act, it is not always clear what the tax consequences are for the taxpayer making these payments.

1.4 RESEARCH OBJECTIVES

It is trite that the taxpayer needs to ensure certainty surrounding their tax position on the making of payments for the right to use intellectual or other property. The purpose of this research is to

- identify the provisions of the Act that specifically provide for the deduction of payments made for intellectual property;
- identify the factors that need to be considered in determining whether a payment made in relation to intellectual property qualifies for any of the specific deductions mentioned above;
- identify the factors that need to be taken into account in determining whether a payment made in respect of intellectual property that does not qualify for any of the specific deductions mentioned above, will qualify for a deduction in terms of section 11(a); and
- design a flow diagram that will assist a taxpayer in determining whether a payment made in respect of intellectual property will qualify for a deduction against its income, either in terms of a specific deduction, or alternatively, in terms of section 11(a).

1.5 RESEARCH METHODS

The following steps will be taken to achieve each of the abovementioned research objectives:

- a survey of authoritative text books on the Act will be conducted in order to identify all the provisions of the Act that provide for a deduction of payments made relating to intellectual property as well as the factors that need to be considered when determining whether a payment for intellectual property meets the requirements of those provisions in the Act;
- court judgments in respect of specific deductions relating to intellectual property will be analysed to determine what effect they may have on the interpretation of the relevant sections of the Act;

- a study will be done of interpretations by the courts of the requirements of the general deduction formula in various cases where payments were made for intellectual property rights and a deduction was sought in terms of section 11(a). The main area of focus will be the capital or non-capital nature of those payments in order to identify factors which should be considered by a taxpayer when making such payments; and
- conclusions reached during the abovementioned steps will be used to design a flow diagram that will provide a guideline for determining the deductibility of the relevant amounts.

1.6 BENEFICIARIES OF THIS STUDY

The study will assist taxpayers (especially for example franchisees), tax advisors, legislators, the South African Revenue Services and business in general in identifying and appreciating the tax consequences of payments made for the use of intellectual or other property.

1.7 LIMITATIONS TO THE STUDY

This research will only deal with payments in respect of intellectual property and the normal tax implications thereof.

Although some of the principles may also apply to payments in respect of the use of real property, such as mining resources, this research will not address payments for any rights in respect of real property.

1.8 GLOSSARY OF TERMS AND DEFINITIONS

1.8.1 “Intellectual Property”

Garner (2009:824) defines intellectual property as a category of intangible rights protecting commercially valuable products of the human intellect, comprising primarily trademark, copyright, and patent rights, but also includes trade-secret rights, publicity rights, moral rights, and rights against unfair competition.

According to Klopper and Van der Spuy (2008:2) intellectual property “denotes the incorporeal property created by the mental labour, activity and creativity of a human

being”. Klopper *et al.* (2008:6) states that the following intellectual property is presently recognised by our law:

- goodwill and trade marks;
- the idea central to copyright;
- the idea central to patents and designs; and
- the idea central to plant breeders’ rights.

The term “intellectual property” refers to several types of intangible property (property which cannot be perceived by the senses). The fiscus has recognised the value of this intellectual property by classifying it as a cost to business that should be tax deductible (Schembri, 2007:155)

Subjective rights such as intellectual property rights cannot be the object of another subjective right, such as ownership. Since ownership (a real right) has as its object a corporeal thing, it cannot be said that a person obtains ownership of intellectual property rights. For this reason a person holding an intellectual property right is referred to as the legal holder of such right, and not as the owner of such right (Klopper *et al.*, 2008:6).

1.8.2 “Royalty”

“Royalty” is defined as the compensation, consideration or fee paid for a license or privilege to use an intellectual property (brand, copyright, patent, process) or a natural resource (fishing, hunting, mining), computed usually as a percentage of revenue or profit realised from the use. (BusinessDictionary.com. Not dated.)

Oxford Dictionaries online (oxforddictionaries.com. Not dated.) defines “royalty” as a sum paid to a patentee for the use of a patent or to an author or composer for each copy of a book sold or for each public performance of a work.

Garner (2009:1356) provides two separate definitions of “royalty”. The first definition, which deals with intellectual property, defines “royalty” as “a payment made to an author or inventor for each copy of a work or article sold under a copyright or patent”. The definition is further expanded by referring to an established royalty as “a royalty set at an agreed on price”, while a reasonable royalty is referred to as “a royalty that a licensee would be

willing to pay the holder of the thing's intellectual property rights while still making a reasonable profit from its use".

The second definition deals with oil, gas and mineral rights. This part defines "royalty" as "a share of the product or profit from real property, reserved by the grantor of a mineral lease, in exchange for the lessee's right to mine or drill on the land". An example of such royalties is haulage royalties paid to a landowner for moving coal via a subterranean passageway under the landowner's land from a mine located on an adjacent property. This type of royalty is typically calculated as a certain amount per ton of coal hauled. Another example is mineral royalty which is defined as "a right to a share of income from mineral production".

As far as royalties are concerned, this research will only deal with the first type of royalty, which is paid in respect of intellectual property. Although some of the principles may also apply to the second type of royalty, this research will not address payments for any rights in respect of real property.

1.8.3 "License fee"

Garner (2009:938) defines "license" as "a permission, usually revocable, to commit some act that would otherwise be unlawful".

"Licensing" is defined as "the sale of a license authorizing another to use something (such as computer software) protected by copyright, patent or trademark" (Garner, 2009:940). The licensor is one who grants a license to another, while the licensee is one to whom a license is granted.

"Exclusive license" is referred to as "a license that gives the licensee the sole right to performed the licensed act, often in a defined territory, and that prohibits the licensor from performing the licensed act and from granting the right to anyone else" (Garner, 2009:938).

A "license fee" is defined as "a charge of this type accompanied by a requirement that the licensee take some action, or be subjected to regulation or restrictions" (Garner, 2009:940).

With regard to the use of intellectual property, “license fee” and “royalty” payments made are similar in nature.

1.8.4 “Franchise”

A “franchise” is defined by Garner (2009:658) as “[a] privilege granted or sold, such as to use a name or to sell products or services. The right given by a manufacturer or supplier to a retailer to use his products and name on terms and conditions mutually agreed upon”. It is further stated by Garner (2009:658) that a franchise is basically a license from the owner of a trade mark or trade name which permits someone to sell a product or service under that name or mark. The definition is further elaborated on by stating that “a franchise has evolved into an elaborate agreement under which the franchisee undertakes to conduct a business or sell a product or service in accordance with methods and procedures prescribed by the franchisor, and the franchisor undertakes to assist the franchisee through advertising, promotion and other advisory services”.

1.9 OVERVIEW OF CHAPTERS

Chapter one of this study provides the background and introduction to the research problem, as well as the research objectives and methods to be followed.

Chapter two presents an overview of the specific income tax deductions available to taxpayers in respect of payments that relate to intellectual property.

Chapter three considers the requirements of the general deduction formula in the context of payments for intellectual property rights which do not qualify for any specific income tax deduction.

Chapter four provides an overview of the conclusions reached during the study as well as a flow diagram which summarises the deductions as identified and discussed in the previous chapters.

CHAPTER 2

SPECIFIC INCOME TAX DEDUCTIONS AVAILABLE TO TAXPAYERS IN SOUTH AFRICA

2.1 INTRODUCTION

When a taxpayer makes payments in respect of intellectual property which is used for trade purposes to generate income, it is firstly necessary to determine whether there are any sections of the Act which may specifically allow for the deduction of those amounts paid. If no specific deduction is provided for, deductions may be sought in terms of the general deduction formula (see Chapter 3).

This chapter will focus on the various specific sections of the Act that could have an impact on any possible deductions available to a taxpayer.

2.2 CARRYING ON A TRADE

It must be noted that the deductions discussed in this study are available in terms of section 11 (other sections may have an impact on the amount and timing of such deductions, eg. sections 23B and 23I).

Before a taxpayer may claim a deduction in terms of section 11, the taxpayer must be carrying on a trade and must be earning income from that trade. This requirement is stated in the introduction to section 11 and is therefore applicable, whether the taxpayer seeks to deduct an amount in terms of the general deduction formula (section 11(a) – see Chapter 3) or as a specific deduction in terms of the rest of the provisions of section 11.

The term “trade” is defined in section 1 of the Act as including:

“every profession, business, employment, calling, occupation or venture, including the letting of property and the use of or the grant of the permission to use any patent as defined in the Patent Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No 195 of 1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No 194 of 1993), or any copyright as defined in the Copyright Act, 1978 (Act No 98 of 1978), or

any other property which in the opinion of the Commissioner is of a similar nature”.

This wide definition clearly will include the use of most types of intellectual property by the taxpayer in exchange for the payment of royalties to the creator of such intellectual property.

Section 11 refers to the “carrying on” of a trade and it is therefore preferable that there is continuity to the activities of the taxpayer and that there is a reasonable prospect of achieving profits/taxable income if he wants to prove that he is indeed carrying on a trade and to deduct expenses in terms of section 11(a). Continuity and profit motives are, however, not prerequisites for the carrying on of a trade. Whether the taxpayer is carrying on a trade or not is a question of law and must be decided on the facts surrounding each case (De Koker 2010:§7.2). This principle was established in *CIR v Stott*, 1928 AD 252 (3 SATC 253), where Wessels JA stated that “whether he was or was not carrying on such a business was an inference from facts. That inference was a matter of law”.

It is therefore essential that the taxpayer proves (onus of proof in terms of section 82) that a trade is carried on before attempting to deduct payments in respect of intellectual property in terms of the specific deductions provided for and discussed in this chapter.

2.2.1 Pre-trade expenditure and losses

In some cases the taxpayer may incur expenses before commencing to trade. In terms of section 11 these expenses would not be deductible, as there is no trade being carried on. Section 11A was introduced into the Act in 2003 to deal with such pre-trade expenses.

Section 11A allows the deduction of expenses incurred by a taxpayer prior to commencement of trade, provided the following requirements are met:

- a trade must be carried on;
- the expenditure must have been incurred by that person before the commencement of that trade;
- the expenditure must qualify as a deduction in terms of section 11 (except section 11(x)), 11B, 11D or 24J); and

- the expenditure must not have been claimed or allowed as a deduction previously.

According to the Explanatory Memorandum on the Revenue Laws Amendment Bill (2003:52) the purpose of section 11A is to provide taxpayers investing in new business ventures with a special deduction for start-up costs incurred before the commencement of trade. This deduction will, however, be ring-fenced, in the sense that any loss from a trade in respect of which section 11A is claimed, may not be set off against any income from any other trade earned by the taxpayer for that period of assessment. The loss will have to be carried forward and set off against income from the same trade in the following year of assessment (section 11A(2)).

This section should therefore address the taxpayer's uncertainty with regard to deductibility of royalties or other intellectual property fees paid prior to actual trading taking place. These expenses could still be considered for deduction along the guidelines of this study once taxable income is derived from the trade, providing all the requirements of section 11A are met.

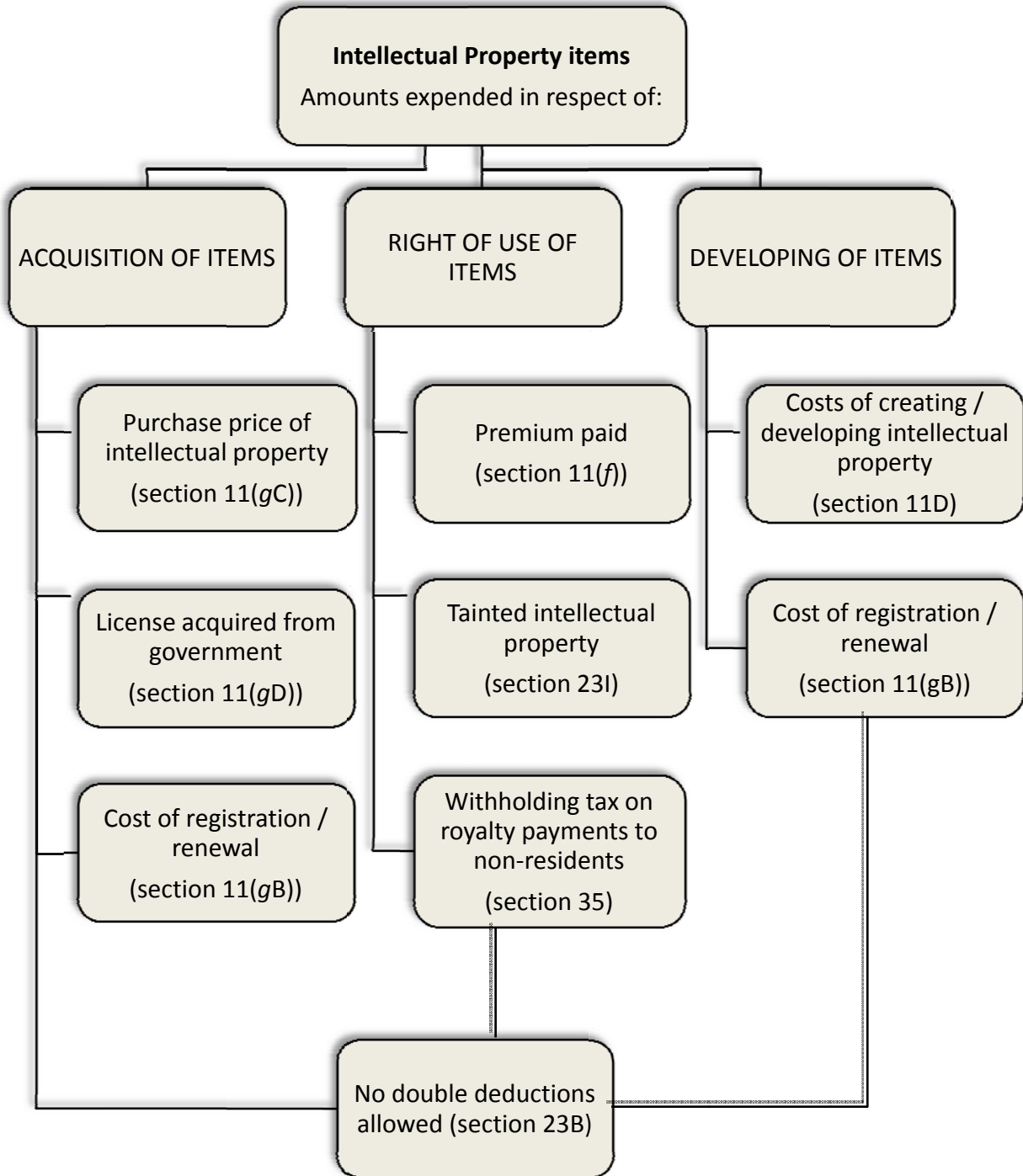
2.3 SPECIFIC SECTIONS OF THE ACT AFFECTING INTELLECTUAL PROPERTY DEDUCTIONS

The amount and timing of the various specific deductions depend on whether the taxpayer has spent amounts on developing or acquiring the intellectual property items or whether payments were merely made to someone else for the use of these items.

It is important to remember that, in terms of section 82 the onus of proof will be on the taxpayer to prove that a deduction must be allowed. It is therefore the taxpayer's responsibility to ensure that the requirements of the relevant section are met before a deduction is claimed.

A summary of the specific deductions as well as other sections of the Act which could affect the deductions, classified according to the nature of the expenditure, is provided in figure 1 below.

Figure 1: Specific sections relating to intellectual property



2.4 ACQUISITION OF INTELLECTUAL PROPERTY ITEMS

2.4.1 Purchase of intellectual property - section 11(gC)

This specific deduction section deals with the acquisition (purchase) of certain intellectual property items, as opposed to the situation where the taxpayer might develop their own intellectual property or merely make payments for the use of someone else's.

Section 11(gC) only applies to expenditure incurred to acquire certain intellectual property items on or after 1 January 2004.

Expenditure incurred prior to 1 January 2004 had to be deducted in terms of section 11(gA). Section 11(gA) used to provide for deductions for the cost of acquiring certain intellectual property items (the type of expense examined in this part of the study), but also for costs incurred by a taxpayer in developing their own intellectual property. In terms of a 2003 amendment to the Act, acquisition costs of intellectual property have to be claimed in terms of section (gC), while costs of developing or devising (research and development costs) had to be claimed in terms of section 11B (which has subsequently been replaced by section 11D).

Reasons for these changes were provided in the Explanatory Memorandum on the Revenue Laws Amendment Bill (2003:23-24) in which it was stated that the South African rules have become obsolete and too restrictive and do not go far enough in recognising modern day developments. It was argued that a more flexible system that is in line with modern reality that encourages innovation, and is comparable to international trends is appropriate. It is also stated in this Memorandum that research and development provisions should provide "a more generous tax dispensation" and that the concern in respect of buying intangible property is adequately dealt with in other provisions. In other words, the main reason for the change from section 11(gA) to sections 11(gC) and 11B (and subsequently section 11D) seems to be to allow for more flexible provisions with regard to research and development in order to encourage such activities undertaken by taxpayers.

Consequently, section 11(gC) was introduced to provide for the deduction of purchased intellectual property. This section is very similar to the part of section 11(gA) that dealt with purchased intellectual property. It applies to the same types of property (except that

section 11(gA) allowed for deductions on the cost of trade marks up to 29 October 1999, while section 11(gC) completely disallows the deduction of expenses incurred for the acquisition of trade marks) and provides for the same write-off periods offered by section 11(gA).

Section 11(gC) will apply when it is evident that a taxpayer in fact purchased the intellectual property items as well as any necessary support services in respect of the use of such items. In this regard, it will be necessary to thoroughly investigate the agreement in respect of the intellectual property to determine whether the taxpayer is acquiring the property itself or merely paying a premium for the right of use.

The section applies to the acquisition of any:

- invention or patent as defined in the Patents Act;
- design as defined in the Designs Act ;
- copyright as defined in the Copyright Act;
- other property which is of a similar nature (other than Trade Marks as defined in the Trade Marks Act ; or
- knowledge essential to the use of such patent, design, copyright or other property or the right to have such knowledge imparted. (Section 11(gC).)

2.4.1.1 Definition of “invention / patent”

According to Klopper *et al.* (2008:219) the meaning of an “invention” can be found in the wording of section 25(1) of the Patents Act, which stipulates that “[a] patent may, subject to the provisions of this section, be granted for any new *invention* which involves an inventive step and which is capable of being used or applied in trade or industry or agriculture”.

In terms of section 25(1) of the Patents Act an invention must be new, it must involve an inventive step, and it must be capable of being used or applied. It therefore implies that there must be a useful idea, plan or program which can produce or achieve something useful.

“Invention” is defined as a patentable device or process created through independent effort and characterized by an extraordinary degree of skill or ingenuity; a newly discovered art or operation (Garner, 2009:843).

“Patent” is defined by the Companies and Intellectual Property Registration Office (CIPRO) of the Department of Trade and Industry of South Africa as “an exclusive right granted for an invention, which is a product or process that provides a new way of doing something, or offers a new technical solution to a problem. The patent provides protection for the owner, which gives him/her the right to exclude others from making, using, exercising, disposing of the invention, offering to dispose, or imparting the invention”. (Cipro.co.za. Not dated.)

2.4.1.2 Definition of “design”

Garner (2009:478) defines a “design” as “a plan or scheme” and also as “the pattern or configuration of elements in something, such as a work of art” or “the drawing or the depiction of an original plan for a novel pattern, model, shape, or configuration that is chiefly decorative or ornamental”. According to this definition a design may sometimes be protected as a trademark.

The Designs Act identifies two types of designs, namely aesthetic and functional designs.

According to the Companies and Intellectual Property Registration Office (CIPRO) of the Department of Trade and Industry of South Africa a “design” is about shape and features that appeal to the eye. Some designs are necessitated by function and others are aesthetic. Design is about the shape, form, appearance, pattern, ornamentation and configuration of a product or article. (Cipro.co.za. Not dated.)

2.4.1.3 Definition of “copyright”

According to Klopper *et al.* (2008:12) the term copyright is usually used to denote the right that an author vests in his work. The entitlements conferred to the holder of copyright (usually the author) or a person authorised by such holder, entitles the holder to exclusively control, use and adapt a work.

In terms of the Copyright Act there are certain categories of “works” in which copyright may subsist. These works are:

- literary works, including novels, textbooks, articles, lectures, tables and speeches;

- musical works, defined in the Copyright Act as “a work consisting of music, with the exclusion of any words or action intended to be sung, spoken or performed with the music”;
- artistic works, such as paintings, sculptures, drawings, photographs and works of architecture such as models or buildings;
- sound recordings, defined in the Copyright Act as “any fixation of sounds capable of being reproduced but does not include a soundtrack associated with a cinematograph film”. According to Klopper *et al.* (2008:17) one must distinguish between the copyright in the sound recording itself and the copyright of the author of the music and/or words;
- cinematograph films, defined in the Copyright Act as “any fixation or storage by any means whatsoever on film or any other material of data, signals or a sequence of images capable, when used in conjunction with any mechanical, electronic or other device, of being seen as a moving picture and of reproduction and includes the sounds embodied in the soundtrack associated with the film, but shall not include a computer program”. It is necessary to distinguish between the screen play as a literary work and the film itself (Klopper *et al.*, 2008:17);
- programme-carrying signals, defined in the Copyright Act as “a signal embodying a program, which is emitted and passes through a satellite”. Copyright therefore vests in the signals themselves, while the signals may be carrying material which in itself is subject to separate copyright. The holder of copyright in a programme carrying signal is the person who first transmits the signal to a satellite (Klopper *et al.*, 2008:19);
- broadcasts, defined in the Copyright Act as “a telecommunication service of transmissions consisting of sounds, images, signs or signals”. Once again, copyright exists in the broadcast itself and the material being broadcast separately (Klopper *et al.*, 2008:18);
- published edition, which according to the Copyright Act means “the first print by whatever process of a particular typographical arrangement of a literary or musical work”. Copyright in the typographical layout and point setting of a specific literary or musical work will vest in a publisher separately from the copyright which vests in the author or composer of such a work; and
- computer programs, 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". Video games will be included in this category. According to Klopper *et al.* (2008:19) a computer program must be converted into a material form (for example saved on a hard drive) before it will qualify for copyright protection.

2.4.1.4 Definition of "trade mark"

Garner (2009:1531) states that a trade mark is defined as "[a] word, phrase, logo, or other graphic symbol used by a manufacturer or seller to distinguish its product or products from those of others. The main purpose of a trade mark is to designate the source of goods or services. In effect, the trade mark is the commercial substitute for one's signature."

According to the Trade Marks Act a trade mark "other than a certification mark or a collective mark, means a mark used or proposed to be used by a person in relation to goods or services for the purpose of distinguishing the goods or services in relation to which the mark is used or proposed to be used from the same kind of goods connected in the course of trade with any other person".

Klopper *et al.* (2008:138) states that trade marks can be divided into two groups. Firstly, some marks may distinguish the products and services of a business and secondly, other marks may distinguish or identify the business as such. Although the actual trade mark and packaging of a product fall into the first category, and the trade name of a business falls into the second category, a business may use the same mark as both a trade mark and trade name, for example the Coca-Cola trade mark.

According to the Companies and Intellectual Property Registration Office (CIPRO) of the Department of Trade and Industry of South Africa a trade mark is "a brand name, a slogan or a logo. It identifies the services or goods of one person and distinguishes it from the goods and services of another". (Cipro.co.za. Not dated.)

2.4.1.5 "Property of a similar nature"

Meyerowitz (2008:12-96) states that, in the context of patent, design, trade mark or copyright, all of which terms refer to rights protected by statute, the reference to "other property of a similar nature" carries a question mark, because in the absence of statutory protection the possessor of a secret formula or a process or a mark etc. has no property

which he can protect, except perhaps in the form of a passing off action in common law, or an interdict against particular individuals.

In *ITC 1726* (64 SATC 236) a taxpayer wanted to deduct license fees paid in respect of the acquisition of cellular license fees as well as for the renewal of such fees. The taxpayer was not allowed a deduction for the acquisition of the license in terms of section 11(a) (see chapter 3), but contended that a deduction should be allowed in terms of section 11(gA) since the license could be regarded as "property of a similar nature" (as stated above, section 11(gC) is currently applicable, but both sections allow for the deduction in respect of "property of a similar nature"). The court held that the ordinary grammatical interpretation of the phrase 'property of a similar nature' found in section 11(gA) refers to the acquisition of intellectual property. This means that it applies only to property which came into existence by exercising intellectual powers and in respect of which the law awards the rights and protection of ownership. This type of property may be used either by the inventor himself or by others with the inventor's permission. The court summarised the essential requirements for this type of property as follows:

- the taxpayer must pay an amount to a person in respect of property which that person has created or developed by the use of his own intellect;
- the person who developed the property must have disposed of the right to use the property which he created by his intellect to another; and
- such disposal must be by way of an agreement which passes on to the recipient the well understood rights of use of the property.

It was consequently held that the cellular license could not be regarded as "property of a similar nature" and a deduction for the fee was not allowed in terms of section 11(gA).

In *C:SARS v SA Silicone Products (Pty) Ltd*, 2004 2 All SA 1 (SCA) (66 SATC 131 (SCA)) the phrase "property of a similar nature" was again considered; it was construed by the court as "property possessing fundamental characteristics common to those possessed by the specifically identified properties". The court further held that "[t]he common nature of the identified properties embraces their intellectual origins, i.e. their derivation from a creative mind, the exploitation creating a justifiable monopoly to which the law affords protection to the owner".

It is clear from these decisions that if a taxpayer acquires a right in respect of any other property which is not specifically listed in section 11(gC) the taxpayer will only be entitled to a deduction if he/she can show that property to be the result of the exercise of intellectual powers.

2.4.1.6 Deduction allowed by section 11(gC)

If expenditure is incurred in the acquisition of such qualifying items identified above (other than by way of developing, devising or creating the items himself or herself), which are used by the taxpayer in the production of income, the section allows for the following deductions (commencing during the year of assessment in which they are brought into use for the first time by the taxpayer):

- if the amount incurred in respect of the item is R5 000 or less, the full amount can be deducted once off in the year during which it is brought into use; or
- if the amount exceeds R5 000, the taxpayer is entitled to an annual allowance of 5% of the cost of the item purchased if the item is a patent, invention or copyright. If the item is a design, the annual allowance is 10% instead of 5% (section 11(gC) proviso (aa)).

It is important to note that the purchase of a trade mark will not be allowed as a deduction in terms of this section. The payment for the knowledge essential to the use of such trade mark will similarly not be deductible.

Anon. (2009:114) referred to a media release issued by the Commissioner in Government Gazette No 15951, dated 22 August 1994, in which it was stated that the Commissioner is aware of the fact that some taxpayers may, upon entering into an agreement of purchasing a business, artificially inflate the amount of the purchase price which relates to intellectual property. At that time this would lead to the taxpayer claiming a deduction for the purchase of the intellectual property in terms of section 11(gA). The part of the purchase price relating to goodwill would not be deductible, since it would be capital in nature.

In *ITC 1838 (72 SATC 6)* it was argued by the Commissioner that the part of the purchase price of a radio station that related to the station's trademarks should not be deductible in terms of section 11(gA) due to the fact that it was artificially inflated. The court held that, due to the fact that the section allowed for the deduction of "expenditure actually incurred",

the market value of the trade marks was irrelevant. The taxpayer was allowed a deduction in terms of section 11(gA).

Although no deduction is currently allowed for the purchase of trade marks in terms of section 11(gC) (which has replaced section 11(gA), the abovementioned court decision could nevertheless have an impact when other types of intellectual property are acquired as part of the purchase of a business. According to Keyser and Mostert (2009:168) it is important for taxpayers purchasing an entire business as a going concern, to determine the exact nature of all the assets they are acquiring. If any of those assets are of the type referred to in section 11(gC), they may be entitled to a specific deduction.

In this regard Keyser and Mostert (2009:168) suggest that the taxpayer obtains expert advice when acquiring trademarks from a seller. They suggest that the taxpayer should establish whether copyright subsists in those trademarks and allocate the appropriate portion of the purchase price to such copyright. They also state that a name does not enjoy copyright protection, but a logo may enjoy copyright protection as an artistic work. The copyright in a logo may be a particularly valuable asset and may provide certain tax deductions.

In conclusion, if it is established that a taxpayer incurred expenditure by means of purchasing a patent, design, copyright or other similar property, it is in terms of this section that the taxpayer may qualify for a specific deduction in respect of the cost of the intellectual property if all of the requirements listed above have been met. As mentioned before, the onus of proof in this regard is on the taxpayer (section 82).

2.4.2 License acquired from government - section 11(gD)

As from 1 January 2008, if a taxpayer incurs expenditure in acquiring a license from the Government, a provincial administration, municipality or an institution or entity contemplated in Schedule 1 or Part A or C of Schedule 3 to the Public Finance Management Act 1 of 1999, the taxpayer will qualify for the deduction of an allowance based on the expenditure incurred in acquiring the license (excluding expenditure in respect of infrastructure).

This allowance is only available to taxpayers whose trade is

- the provision of telecommunication services;

- the exploration, production or distribution of petroleum; or
- the provision of gambling facilities.

If the abovementioned requirements are met, the taxpayer may deduct the expenditure incurred to acquire the license over the lesser of the remaining number of years of use of the license by the taxpayer or 30 years.

Since this section only relates to the mentioned types of licenses, there is no specific deduction for other types of licenses acquired by taxpayers not listed in section 11(gD) (for example an amount paid by a taxpayer for a license in respect of intellectual property – see Chapter 1.8.3 for a definition of “license”).

The reason for this section being discussed here is to eliminate uncertainty as to which section could offer a deduction in respect of license fees paid. As far as intellectual property is concerned, a taxpayer should argue that expenditure incurred in acquiring licenses may be deductible in terms of section 11(gC) as "other property which is of a similar nature".

2.4.3 Registration / renewal cost of intellectual property - section 11(gB)

It is stated by Schembri (2007:155) that if a taxpayer develops or obtains an item that qualifies for protection in terms of statutes (eg. patents, trade marks and designs) he acquires a right to exclusively exploit the item himself to the exclusion of all others or to sell the item. The right to exclusively exploit the intellectual property only lasts for the duration of its registration.

According to the Companies and Intellectual Property Registration Office (CIPRO) of the Department of Trade and Industry of South Africa a trade mark can only be protected as such and defended under the Trade Marks Act if it is registered. Un-registered trade marks may only be defended in terms of common law. (Cipro.co.za. Not dated.)

This principle also applies to the registration of patents and designs. Therefore, in order to enjoy statutory protection in respect of their intellectual property rights, South Africans have to register the intellectual property with CIPRO. Registration and renewal fees may be charged when such property rights are registered.

If the taxpayer incurs such expenditure in respect of obtaining or extending the registration of a patent, design or trade mark, the expenditure may be deducted by the taxpayer in the year of assessment in which it was incurred, provided the patent, design or trade mark is used by the taxpayer in the production of his or her income (section 11(gB)). This deduction for registration or renewal costs will be available, whether the taxpayer has purchased or developed the relevant property.

This section therefore serves to remove uncertainty with regard to the deductibility of registration and renewal fees paid, which are considered separately from the actual purchase or development costs of the intellectual property.

2.5 RIGHT OF USE OF INTELLECTUAL PROPERTY ITEMS

In these cases the taxpayer makes certain payments for the right to use intellectual property. The taxpayer does not become the holder of the intellectual property.

2.5.1 Premiums paid for the right of use of intellectual property (section 11(f))

Payments made in respect of premiums will generally not qualify for deduction in terms of the general deduction formula, since they are usually regarded as of a capital nature (see Chapter 3 discussion of section 11(a)). Section 11(f) therefore allows for the deduction of the premium paid over the expected period of use of the underlying intellectual property item. The taxpayer will need certainty as to whether a payment made in respect of the use of intellectual property can be regarded as a premium. If a payment is regarded as a premium, the taxpayer needs to establish the amount allowed as a specific deduction.

Section 11(f) allows for the deduction of an allowance in respect of any premium or consideration in the nature of a premium paid by a taxpayer for the right of use of (among others):

- any "patent" as defined in the Patents Act;
- any "design" as defined in the Designs Act;
- any "trade mark" as defined in the Trade Marks Act;
- any "copyright" as defined in the Copyright Act ; or
- any other property which is of a similar nature

if such patent, design, trade mark, copyright or other property is used for the production of income or income is derived therefrom (section 11(f)(iii)).

2.5.1.1 Meaning of "premium or consideration in the nature of a premium"

Section 11(f) refers to any "premium or consideration in the nature of a premium" paid by the taxpayer. It has been held in *CIR v Butcher Bros (Pty) Ltd*, 1945 AD (13 SATC 21) that this means consideration in the nature of rent passing from a lessee to a lessor over and above or in lieu of the rental payments. For example, a taxpayer may pay to the registered holder of a patent an amount of R100 000 to secure the right to use that patent in that taxpayer's income producing activities, as well as a monthly amount of R10 000 for the actual use of the patent. The R100 000 may be regarded as a premium as it is payable in addition to the monthly usage charge (which can be likened to "rent" paid). It is this R100 000 premium for which the taxpayer may seek a deduction in terms of section 11(f). A deduction for the monthly charge of R10 000 may be available to the taxpayer in terms of the general deduction formula (see Chapter 3) if all of the requirements of section 11(a) have been met.

Having regard to the circumstances of the taxpayer, it may be apparent that the payment(s) made by the taxpayer for the use of intellectual property constitute the securing of a right to use the relevant intellectual property items. These payments are in other words not seen as amounts expended for the continued use of the assets, but rather for the acquisition of an income producing structure. Under these circumstances these payments could be classified as a "premium" paid by the taxpayer for the right to use the intellectual property, which may qualify for deduction in terms of section 11(f) of the Act.

The section therefore relates to the right of use of the listed intellectual property items and not to the outright purchase of those items. If the intellectual property rights are purchased, the taxpayer will need to consider a deduction in terms of section 11(gC).

The exact extent of the section 11(f) allowance is determined by four provisos to the section (provisos (aa) to (dd)).

2.5.1.2 Allowance in respect of amount paid for right of use (provisos (aa) and (bb) to section 11(f))

The amount of the deduction which may be claimed in any year of assessment by a taxpayer is determined by proviso (aa) to section 11(f) as the amount of the premium divided by the number of years during which the taxpayer will have the right to use such asset. The number of years over which the deduction of the amount is spread is limited to twenty five years.

If the taxpayer pays the premium for the use of the asset for an indefinite period, or if the taxpayer has the right to renew the agreement after its expiry, the period over which the deduction is to be spread, is the period which the Commissioner deems to be the probable duration of such use (still limited to twenty five years) (section 11(f) proviso (bb)).

2.5.1.3 Allowance in respect of amount paid for imparting of knowledge connected with the use of intellectual property (proviso (cc) to section 11(f))

Section 11(f) also allows for a deduction in a situation where a taxpayer pays a premium or consideration in the nature of a premium for "the imparting of or the undertaking to impart any knowledge directly or indirectly connected with the use of such ... patent, design, trade mark, copyright or other property as aforesaid" (section 11(f)(iv)).

The allowance which may be deducted for any year of assessment for this type of premium is determined by proviso (cc) to section 11(f) as the amount of the premium which the Commissioner may allow. It is provided that the Commissioner will take into account the period during which the taxpayer will have the right of use of the underlying intellectual property, as well as all other relevant circumstances. Therefore, while the deduction for the premium for the right of use of the intellectual property is automatic, this deduction is determined by the discretion of the Commissioner.

This implies that when a taxpayer pays a premium in terms of an agreement for the use of the listed intellectual property items, it will be important to determine which part of the premium relates to the right to use the property and which part relates to securing the right to the knowledge in respect of such property (for example the right to obtain support from the holder of the right during the duration of the agreement).

2.5.1.4 No allowance if the amount paid is not income in hands of recipient (proviso (dd) to section 11(f))

Proviso (dd) states that the section 11(f) allowance may not be claimed "in relation to any such premium or consideration paid by the taxpayer which does not for the purposes of this Act constitute income of the person to whom it is paid...". An example of this situation is where a taxpayer pays such a premium to a non-resident taxpayer, who may (in terms of the definition of "gross income" in section 1 of the Act) not have included it in their "income" if it was not from a source within or deemed to be within South Africa. Another example is where a taxpayer pays such a premium to a tax exempt body (for example a Public Benefit Organisation).

Taking into account the provisions of section 23B as discussed further on, it is important to note that, should the taxpayer not be granted a deduction for the portion of their payment which is regarded as a premium, the taxpayer may not seek a deduction for it in terms of the general deduction formula. According to Clegg (2006:37) the taxpayer could argue that because the amount does not qualify for deduction in terms of section 11(f) it cannot be limited by section 23B, as it then has not qualified for deduction under more than one section of the Act. It is however, also stated that the Commissioner may not agree with this interpretation.

The taxpayer may also not claim the portion allowed by section 11(f) for a specific year of assessment and then claim the remaining portion in the same year of assessment in terms of the general deduction formula.

The taxpayer will also need to take into account the provisions of section 23I, which apply to expenditure in respect of "tainted intellectual property" and which could prohibit the deduction of such expenditure, even if the requirements of section 11(a) are met.

In summary, a taxpayer paying for the right of use of intellectual property should determine which part of the payment (if any) is in respect of obtaining the right to use the property as such. If this amount is included in the income of the recipient of the amount, the taxpayer may qualify for an allowance spread over the period of the right of use.

2.5.2 Tainted intellectual property - section 23I

This section was recently introduced into the Act and applies to expenditure incurred by a taxpayer in respect of certain intellectual property items on or after 1 January 2009.

It may happen that amounts paid by a taxpayer in respect of intellectual property (for example royalties paid for the use of a patent) are not included in the income of the recipient. This could happen if the recipient is, for example a non-resident arguing that the royalties received are not from a source or deemed source in South Africa or if they are paid to bodies which are exempt from tax. The aim of section 23I is to prevent avoidance of tax through the possible abuse of this situation by taxpayers who set up structures intended to make tax deductible payments to non-taxable persons (De Koker, 2010:§7.48A).

The definition of "intellectual property" in section 23I(1) includes any

- patent as defined in the Patents Act, including any application for a patent in terms of that Act;
- design as defined in the Designs Act;
- trade mark as defined in the Trade Marks Act;
- copyright as defined in the Copyright Act, 1978;
- 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;
- property or right of a similar nature to that in paragraph (a), (b), (c), (d) or (e); and
- knowledge connected to the use of such patent, design, trade mark, copyright, property or right.

These are the main categories of intellectual rights which this research deals with.

This section prohibits the deduction by a taxpayer of expenditure incurred for the use of (in terms of section 11(a)), right of use or permission to use (in terms of section 11(f)) tainted intellectual property to the extent that the amount of the expenditure does not constitute income received by or accrued to any other person or to the extent that the amount of expenditure does not constitute a proportional amount of net income of a controlled foreign

company which is included in the income of any resident of South Africa in terms of section 9D (section 23l(2)(a)). It also disallows the deduction of expenditure if the amount of such expenditure is determined directly or indirectly with reference to expenditure incurred for the use, right of use or permission to use tainted intellectual property to the extent that the amount is not included in another person's income as indicated (section 23l(2)(b)).

“[T]ainted intellectual property” means intellectual property

- which was the property of the end user or of a taxable person that is or was a connected person, as defined in section 31 (1A), in relation to the end user;
- which is the property of a taxable person;
- a material part of which was used by a taxable person in carrying on a business while that property was the property of a taxable person and the end user of that property acquired that business or a material part thereof as a going concern; or
- which was discovered, devised, developed, created or produced by the end user of that property, or by a taxable person that is a connected person, as defined in section 31 (1A), in relation to the end user, if that end user, together with any taxable person that is a connected person in relation to that end user, holds at least 20 per cent of the participation rights, as defined in section 9D, in a person by or to whom an amount is received or accrues
 - by virtue of the grant of use, right of use or permission to use that property; or
 - where that receipt, accrual or amount is determined directly or indirectly with reference to expenditure incurred for the use, right of use or permission to use that property (section 23l(1)).

“[T]axable person” means any person other than—

- a person that is not a resident;
- the Government, a provincial administration or a municipality contemplated in section 10 (1) (a);
- an institution, board or body contemplated in section 10 (1) (cA);

- any public benefit organisation as defined in section 30 that has been approved by the Commissioner in terms of that section;
- any recreational club as defined in section 30A that has been approved by the Commissioner in terms of that section;
- any company or trust contemplated in section 37A;
- any fund contemplated in section 10 (1) (d) (i) or (ii); or
- any person contemplated in section 10 (1) (f) (section 23I(1)).

“End user” means a taxable person or a person with a permanent establishment within the Republic that uses intellectual property or any corresponding invention during a year of assessment to derive income, other than a person that derives income mainly by virtue of the grant of use, right of use or permission to use intellectual property or any corresponding invention (section 23I(1)).

Section 23I does not apply to expenditure incurred for the acquisition of intellectual property, which would still be deductible in terms of section 11(gC), regardless of whether the requirements of section 23I are met. Section 23I also does not apply to deductions in respect of trading stock (section 23I(2)).

The Explanatory Memorandum on the Revenue Laws Amendment Bill (2007:33) states that the reason for this denial of deductions is that much of the intellectual property created by taxable South African residents is subsidised by government funding, South African tax allowances (such as sections 11(gA) and 11(gC) and the 150 per cent research and development allowance of section 11D) and general South African infrastructure. This South African subsidised intellectual property should not be permitted to be used as a tool to erode our tax base.

It could happen that royalties paid to a non-resident in respect of tainted intellectual property results in a liability to withhold the 12% withholding tax stipulated by section 35. If the taxpayer has withheld the 12% withholding tax in respect of royalties paid on such tainted intellectual property, the taxpayer will be allowed to deduct one third of the royalty or premium payment (provided the requirements of section 11(a) or 11(f) are met). In other words, there will not be a complete prohibition of the deduction.

Some double tax agreements reduce the royalty withholding tax rate to zero percent, 5% or 10%, depending on the tax treaty partner (De Koker, 2010:§7.48A). If the rate of the

withholding tax is reduced to less than 10% in terms of a double tax agreement, no deduction will be allowed (section 23I(3)).

In other words, the taxpayer needs to be aware that section 23I may affect the deductibility of amounts paid for the right of use of intellectual property.

2.5.3 Withholding tax on royalty payments to non-residents - section 35

Although section 35 does not provide for a specific deduction to a taxpayer who makes royalty payments, it is important that the taxpayer is aware of the responsibility imposed by this section. In terms of this section a non-resident is liable for a final withholding tax of 12% of the gross amount of royalties paid to the non-resident. This withholding tax also applies when premiums are paid in respect of the right of use of intellectual property. The section is only applicable in cases where certain intellectual property is used in South Africa.

It is the responsibility of the person who incurs a liability to pay royalties or premiums to a non-resident to pay the withholding tax to the Commissioner within 14 days after the end of the month during which the liability for payment is incurred (section 35(2)(a)). The taxpayer making the royalty or premium payment to the non-resident has the right to withhold the amount of the tax from the payment or recover the tax from the non-resident (section 35(2)(b)).

The amounts to which section 35 applies are amounts paid to non-residents (excluding controlled foreign companies) in respect of

- the use or right of use in the Republic of, or the grant of permission to use in the Republic any
 - patent as defined in the Patents Act;
 - design as defined in the Designs Act;
 - trade mark as defined in the Trade Marks Act;
 - copyright as defined in the Copyright Act;
 - model, pattern, plan, formula or process or any other property or right of a similar nature; or
 - motion picture film, or any film or video tape or disc for use in connection with television, or any sound recording or advertising

matter used or intended to be used in connection with such motion picture film, film or video tape or disc;

wheresoever such patent, design, trade mark, copyright, model, pattern, plan, formula, process, property, right, motion picture film, film, video tape or disc, sound recording or advertising matter has been produced or made or such right of use or permission has been granted or payment for such use, right of use or grant of permission has been made or is to be made, and whether such payment has been made or is to be made by a person resident in or outside the Republic; or

- 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, wheresoever such knowledge or information has been obtained or such knowledge or information has been imparted or is to be imparted or such assistance or service has been rendered or is to be rendered or any such undertaking has been given, and whether payment for such knowledge, information, assistance, service or undertaking has been made or is to be made by a person resident in or outside of the Republic. (Section 35(1).)

The provisions of section 35 are not applicable to amounts paid to a non-resident if such amounts are effectively connected with a permanent establishment of that non-resident in South Africa (proviso to section 35(1)).

In conclusion, the taxpayer needs to know the provisions of section 35, as he/she is personally liable for the payment of the withholding tax. If the taxpayer has not withheld the tax from the payment to the non-resident and cannot recover it from the non-resident, it will be an expense for the taxpayer's own account.

2.6 CREATION / DEVELOPMENT OF INTELLECTUAL PROPERTY - SECTION 11D

2.6.1 Costs of creating / developing intellectual property

A taxpayer may also incur expenditure in creating or devising his or her own intellectual property instead of using or purchasing property which belongs to someone else. The taxpayer needs to be sure of how much of the costs of research will be tax deductible.

If a taxpayer incurs expenditure on or after 2 November 2006 in respect of certain research and development activities, section 11D provides for certain deductions. Before this date sections 11(gA) and 11B governed the allowable deductions. As discussed, costs of devising intellectual property were subject to section 11(gA) if the expenses were incurred before 1 January 2004, when section 11B was introduced to encourage research and development activities by taxpayers.

Section 11B was replaced by section 11D in respect of research and development expenditure incurred on or after 2 November 2006. According to the Explanatory Memorandum on the Revenue Laws Amendment Bill (2006:6-7) the reason for this change was once again to improve the set of research and development tax incentives to ensure that local research and development is not at a global competitive disadvantage.

Section 11D encourages taxpayers to undertake these research and development activities by providing for a deduction of 150% of operational expenses directly related to the research, as well as accelerated wear and tear allowances on capital assets utilised for research purposes.

Interpretation Note 50 has been issued by the South African Revenue Service on 28 August 2009 to provide guidance on the interpretation of section 11D.

2.6.1.1 Requirements for expenditure to be deductible

Section 11D allows a taxpayer a deduction for two types of research and development expenditure actually incurred:

- expenditure incurred directly for the purpose of the discovery of novel, practical and non-obvious information (section 11D(1)(a)). "Discovery" implies something that already existed and was brought to the discoverer's awareness. "Novel" implies

that the information must be new or unusual and that it must not be available in South Africa or elsewhere (SARS, 2009:6); and

- expenditure incurred directly for the purpose of devising, developing, or creating any
 - invention as defined in section 2 of the Patents Act ;
 - design as defined in section 1 of the Designs Act that qualifies for registration under section 14 of that Act;
 - computer program as defined in section 1 of the Copyright Act ; and
 - knowledge essential to the use of such invention, design or computer program (section 11D(1)(b)).

The section requires that the expenditure must be incurred in South Africa. It does not require that the intellectual property must be registered in South Africa. Therefore, if the taxpayer incurs the expenditure in South Africa but the intellectual property is registered outside of the country, the taxpayer may still qualify for the section 11D deductions (SARS, 2007:22).

Section 11D(1) further requires that the information or the invention, design, computer program or knowledge referred to above, must be of a scientific or technological nature and must be intended to be used by the taxpayer in the production of his or her income or must be discovered, devised, developed or created by the taxpayer for the purposes of deriving income.

A further requirement for the section 11D deduction is that the taxpayer must be earning income from the carrying on of a trade (see discussion of the trade requirement in chapter 3). If a taxpayer incurs research and development expenditure before commencing to trade, he or she may qualify to deduct those expenses in terms of section 11A during the year in which he or she commences to trade (SARS, 2009:10).

Annexure A to Interpretation Note 50 (SARS 2009:34) contains some examples of activities whose expenditure will be eligible for the deduction, including the following:

- scientific or technological planning activities;

- design and construction of apparatus used directly for experiments, such as a pilot plant;
- data collection for use in experiments;
- mathematical modelling used to analyse the results of experiments; and
- design, construction and operation of prototypes used in experiments.

The following expenditure does not qualify for deduction in terms of section 11D:

- prospecting for minerals or exploration for oil or gas or space exploration;
- management or enhancement of internal business processes;
- trade mark creation;
- social sciences or humanities; and
- market research, sales or marketing promotion. (Section 11D(5).)

Annexure B to Interpretation Note 50 (SARS 2009:35) contains some examples of activities whose expenditure will not be eligible for the deduction, including the following:

- commercial, legal and financial activities necessary for research and development and for marketing of the new intellectual property created;
- administration and general support services (such as human resources costs and maintenance of research and development equipment); and
- training required to direct and support a research and development project.

It is important that the research and development activities must have been directly incurred for the purposes as outlined above.

2.6.1.2 Deduction for operational (non-capital) expenditure

If the abovementioned requirements are met, the taxpayer is allowed a deduction of 150% of expenditure actually incurred (section 11D(1)).

There are a number of exceptions to this rule. If one of the following exceptions applies, the expenditure will be deductible at 100% of the amount:

- the extent to which the taxpayer's expenditure is funded by a third party (excluding a government grant). The part of the taxpayer's expenditure which is not covered by a grant, will qualify for the 150% deduction (section 11D(7)); and

- if the expenditure is incurred for the right of use of any property (eg. rent paid in terms of a lease agreement) or if it represents interest incurred as defined in section 24J(1) (section 11D(5B)).

If the taxpayer incurs expenditure to acquire, or for the right to use, any patent, invention, design, copyright, work or knowledge, that expenditure cannot be deducted in terms of section 11D (section 11D(5A)). This means that intellectual property which is acquired with the purpose to conduct research and development therewith, will not qualify for the deduction. The taxpayer will have to seek a deduction in terms of section 11(gC)). Furthermore, it means that, if a taxpayer pays for the right of use of such intellectual property (eg. royalties) those payments may also not be deducted under section 11D. The taxpayer may qualify for a deduction for these amounts in terms of section 11(a) (see chapter 3).

If the taxpayer's research and development expenditure is funded by a government grant, the extent of the deduction for the expenditure depends on whether the government grant is exempt in the hands of the taxpayer or not. If the government grant is not exempt, the deduction will be the following:

- an amount equal to twice the government grant will be deductible at 100%; and
- any excess expenditure incurred that exceeds twice the government grant, will be deductible at 150%.

If the government grant is exempt, there will be no deduction for any expenditure up to the amount of the grant, while the excess of the expenditure over the grant amount, will be deductible at 150% (sections 11D(8) and 23(n)).

2.6.1.3 Deduction for capital expenditure

If a taxpayer incurs expenditure of a capital nature (for example the purchase of a building which will house research and development activities) a deduction may be allowed on the cost of the capital asset in terms of section 11D(2). The deduction is available on the cost of the purchase of any building (or part thereof), machinery, plant, implement, utensil or article, as well as any improvements to any such assets.

The assets must be owned by the taxpayer or acquired in terms of an instalment sale agreement to qualify for the deduction. A further requirement is that the relevant asset

should have been new and unused when brought into use by the taxpayer solely and directly for research and development purposes. It must also be used for the development of intellectual property which will be used in the production of the taxpayer's income.

Provided that all of the requirements have been met, the allowance which the taxpayer is entitled to, is calculated as

- 50% of cost in the year in which the asset is brought into use by the taxpayer;
- 30% of cost in the second year of use; and
- 20% in the third year of use (section 11D(2)).

If the taxpayer is seeking a deduction in respect of any building or part thereof or any improvement to such building or part, that building or part thereof has to be used regularly for research and development purposes and must be specifically equipped for such use (section 11D(4)).

In summary, section 11D is intended to provide tax incentives for research and development activities. The taxpayer incurring such expenditure should be familiar with the workings of this section to address uncertainty which may exist as to the deductions available to the taxpayer. If qualifying research and development expenditure is incurred, the taxpayer could be entitled to deductions for operating expenditure of up to 150%, as well as possible accelerated capital allowances.

2.6.2 Registration / renewal cost of developed intellectual property - section 11(gB)

If the taxpayer incurs expenditure in respect of obtaining or extending the registration of a patent, design or trade mark, the expenditure may be deducted by the taxpayer in the year of assessment during which it was incurred, provided the patent, design or trade mark is used by the taxpayer in the production of his or her income (section 11(gB)).

This section applies to purchased as well as developed intellectual property.

2.7 NO DOUBLE DEDUCTIONS ALLOWED - SECTION 23B

Should an amount that was incurred by a taxpayer possibly qualify for deduction in terms of more than one section of the Act, section 23B restricts the deduction of that amount to a single deduction. In the absence of this section, uncertainty could exist as to whether an

expense could qualify for deduction twice. It would also not be clear which section should be applied to claim a deduction in the event that two or more sections allow for a deduction.

Section 23B(1) provides that an amount, or any part thereof, may only be deducted or otherwise taken into account in the calculation of a taxpayer's taxable income, once. In terms of section 23B(2) this does not apply if a specific deduction section requires that, for an amount to be deductible under that section, the amount must be deducted in terms of another section of the Act. In such a case, both sections will be applicable to the amount.

Section 23B(3) provides that there can be no section 11(a) deduction in respect of any expenditure or loss of a type for which a deduction or allowance may be granted under any other provision of the Act. This means that, should the taxpayer incur an expense in respect of intellectual property and that amount is of a type which may qualify for a specific deduction (eg. the purchase of a patent), the requirements of the specific deduction section (section 11(gC) in such a case) have to be applied. Should the requirements for deduction of the amount not be met, the taxpayer may not then seek to deduct the amount in terms of the general deduction formula.

Furthermore, if the deduction of an amount that qualifies for deduction in terms of a specific section is limited by that section (eg. only 50% of the amount may be deducted) the taxpayer may not seek to deduct the balance of the amount (eg. the other 50% of the amount) in terms of the general deduction formula (section 23B(3)(a)).

Also, if a specific deduction provides that an amount may only be allowed as a deduction or allowance in a subsequent year of assessment, the taxpayer may not deduct the amount in the current year of assessment in terms of the general deduction formula, even if all the requirements of section 11(a) may be met (section 23B(3)(b)).

In other words, this section provides certainty to the taxpayer as to the order in which deductions are to be sought. The taxpayer first has to establish whether the intellectual property expenditure is of a type which is provided for in a specific deduction section. If so, a deduction has to be sought in terms of that relevant section. If not, a deduction may be sought in terms of the general deduction formula.

2.8 CONCLUSION

When a taxpayer uses intellectual property in the production of income, it is essential to determine the exact nature of the expenditure incurred by the taxpayer in order to obtain the use of that property.

It is necessary to firstly determine whether there is a trade being carried on or whether pre-trade expenses have to be accumulated and deducted in terms of section 11A.

It is then necessary to establish whether there are any specific deductions available to the taxpayer:

- if the payments are made for the right to use such property (thereby creating or increasing the income producing structure of the taxpayer), a deduction may be possible in terms of section 11(f);
- if the taxpayer purchases intellectual property (excluding trade marks), the cost may be deductible in terms of section 11(gC). Section 11(gB) may allow for a deduction of the registration or renewal fees payable by the taxpayer;
- section 11(gD) allows for a deduction for certain licences acquired from government;
- in cases where the taxpayer creates or develops his or her own intellectual property, there may be deductions available to the taxpayer in terms of section 11D. Section 11(gB) may allow for a deduction of the registration or renewal fees payable by the taxpayer; and
- there are other specific income tax sections which need to be considered as they could have an impact on the taxpayer making payments for intellectual property, such as sections 23I and 35.

Section 23B furthermore determines that the taxpayer will not be allowed double deductions. If expenditure is deducted in terms of a specific section, it will not be deductible again in terms of section 11(a). Also, if an intellectual property item is covered by a specific section but the taxpayer is for some reason not allowed a deduction, the taxpayer cannot claim in terms of section 11(a).

The study so far has addressed the specific deductions available to a taxpayer in respect of intellectual property.

If payments are made for the on-going use of intellectual property in the production of income, the taxpayer may seek a deduction in terms of section 11(a). All of the requirements of section 11(a) have to be met before a deduction will be allowed. Possible implications of section 23 (such as section 23(g) or section 23I) also have to be borne in mind.

Recent case law has dealt with the capital versus revenue nature of such payments, for example royalty payments in terms of the section 11(a) requirements. The impact of these court cases as well as the relevant legislation as outlined above have to be considered when the deductibility of royalty payments is determined. The requirements of section 11(a) as they apply to intellectual property payments are discussed in chapter 3.

CHAPTER 3

GENERAL DEDUCTION FORMULA - SECTION 11(a)

3.1 BACKGROUND

In the previous chapter the specific deductions which may be available to a taxpayer making payments in respect of intellectual property, have been examined. If no specific deduction is available for a type of payment made, the taxpayer may qualify for a deduction in terms of the general deduction formula.

It is important to note that regard must only be had to the language of the Act when deciding whether a specific expenditure is deductible. In *Sub-Nigel Ltd v CIR, 1948 (4) SA 580 (15 SATC 381)* it was held that “...the court is not concerned with deductions which may be considered proper from an accountant’s point of view or from the point of view of the prudent trader, but merely with the deductions which are permissible according to the Act.”

In *CIR v Manganese Metal Company (Pty) Ltd, 1996 (58 SATC 1 (T))* it was held that the taxpayer’s treatment of incoming and outgoing amounts in his own accounts is relevant in so far as it sheds light on his intention or purpose in acquiring the asset or incurring the expenditure.

3.2 CARRYING ON A TRADE AND PRE-TRADE EXPENDITURE

Before a taxpayer may claim a deduction in terms of section 11, the taxpayer must be carrying on a trade and must be earning income from that trade. In certain cases the taxpayer may qualify to deduct pre-trade expenditure in terms of section 11A. The trade requirement and the section 11A requirements apply to specific deductions as well as the general deduction formula.

3.3 GENERAL DEDUCTION FORMULA

Section 11(a) of the Act allows as a deduction from the taxable income of a person carrying on a trade

- any expenditure and losses;

- actually incurred;
- during the year of assessment;
- in the production of income; and
- provided such expenditure and losses are not of a capital nature.

All of the above elements must be present in respect of an expense before it may be claimed in terms of section 11(a). The main problem when dealing with the deductibility of royalty and similar payments is whether these payments represent expenditure of a capital or non-capital nature. Most of the discussions that follow in this study will therefore assume that the other elements of the general deduction formula are present and do not pose any problems.

3.4 CAPITAL VERSUS NON-CAPITAL

3.4.1 Introduction

In order to be claimed as a deduction in terms of section 11(a) of the Act, an expense must not be of a capital nature. According to De Koker (2010:§7.9) it is often difficult to distinguish between capital and non-capital or “revenue” expenditure. As the meaning of “capital” is not defined in the Act, it is necessary to take into account the numerous court cases that dealt with this issue. These court cases have laid down a number of useful tests that can be applied when ascertaining whether expenditure is of a capital or revenue nature.

This chapter will make an in-depth study of the court cases and tests that are relevant when judging intellectual property payments in particular. Firstly, a study will be conducted of cases that dealt with the general concept of “capital versus non-capital”. Secondly, cases that dealt with payments for intellectual property will be dealt with.

3.4.2 Case law - general principles

A very important test and one which is especially applicable when ascertaining the nature of intellectual property payments, is the one laid down in *New State Areas Ltd v CIR*, 1946 AD 610 (14 SATC 155) by Watermeyer CJ who stated that “[t]he distinction must be remembered between floating or circulating and fixed capital”. It was stated that if capital changes its form frequently while a business is pursuing a profit motive, the capital so

employed will be regarded as floating capital. This will happen when the capital changes form money to goods and vice versa (for example the purchase and sale of stock by a merchant or the purchase of raw material by a manufacturer for the purpose of converting it to a manufactured product). The court held that, when deciding on the deductibility of expenditure, it should be established whether the expenditure can be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing, improving or adding to the income-earning structure.

Watermeyer CJ furthermore stated in this case that “the true nature of each transaction must be inquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure”. The true nature of each expense is a matter of fact and in this regard it is important to look at the purpose of the expense. If an expense is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure. This will be the case, even if the expense is paid in annual instalments. On the other hand, if the expense can be regarded as part of the cost incidental to the performance of the income-producing operations (as opposed to being a part of the cost of acquiring or improving it) it is a non-capital expense even if it is paid in a lump sum.

A similar view was expressed in *CIR v George Forest Timber Co Ltd*, 1924 AD 516 (1 SATC 20) by Innes, CJ who stated that “money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur the income does”. According to this judgment there is a difference between money spent in creating or acquiring a source of profit, and money spent in working it. The former relates to capital expenditure, as it enables a business to yield profits in the future, while the latter is non-capital expenditure, as it is spent in working the business for the present production of profit.

In *SIR v Cadac Engineering Works (Pty) Ltd*, 1965 (27 SATC 61) it was said that “[i]t is clear that the object of capital expenditure in a business is normally to earn income or profits or to increase the income or profits of the business”. The court further explained that even though the owner of a business may incur expenses with the intention to produce income, that intention on its own is not sufficient evidence that the expense is not of a capital nature.

In *Vallambrosa Rubber Co v Farmer*, 1910 (5 TC 529) the Scottish Court of Session held that it has to be determined whether the expenditure was a “once-and-for-all” expenditure

or whether it was likely to recur. According to this test, capital expenditure is something that is going to be spent once and for all, and income expenditure is going to recur regularly. However, this test is not infallible, because a “once-and-for-all” payment may yet be revenue expenditure, and a recurring expenditure may well constitute capital expenditure (De Koker 2010:§7.9).

In the English case *British Insulated and Helsby Cables Ltd v Atherton*, 1926 AC 205 All ER 623 (10 TC 155) the “enduring benefit” test was laid down. In terms of this test, if an expense secures an asset of a sufficiently enduring nature for the taxpayer, it will represent an expenditure of a capital nature. In other words, the expense would be incurred in order to acquire an asset which will yield income for the business for a sufficiently long period.

It is clearly important to determine what time period is to be considered as sufficiently “enduring”. In *COT v N’Changa Consolidated Copper Mines Ltd*, 1964 AC 947 (26 SATC 37) the taxpayer had acquired a right which exhausted itself within the twelve month period during which profits were derived from it. This right was held not to constitute an enduring benefit.

It is evident that the answer to the question whether an enduring benefit has been created, depends on the facts of the case and each case must be judged on its own merits.

In *CIR v VRD Investments (Pty) Ltd*, 1993 (4) SA 330 (C) (55 SATC 368) the notion was rejected that any expenditure which endures for less than a year would automatically be classified as being of a revenue nature, even if it is an expenditure that would normally be of a capital nature.

The taxpayer has to be careful when applying the above tests to the payment of royalties, as the tests laid down by the courts merely serve as general guidelines; no one test can be applied on its own to reach a conclusion. This point was made in *Rand Mines (Mining & Services) Ltd v CIR*, 1997 1 All SA 279 (59 SATC 85) where the court stated that “[a]n abiding problem has been to identify and then synthesize into a reasonably accurate and universally applicable yardstick the factors which are indicative of each of the two classes of expenditure”. According to the judge no conclusive measurement tool has yet been developed and any attempts to do so in the past have been futile. It was concluded that regard must be had for the various useful indicators identified by the courts, but

emphasised that they are not individually conclusive. Taking into account the particular facts and circumstances of each case, all of these factors have to be considered together.

In summary, there are various general factors that need to be considered when deciding whether an amount paid is of a capital nature or not. Generally an amount will be of a capital nature if it is more closely connected to the taxpayer's income generating structure than to the income generating operations or if it creates an enduring benefit for the taxpayer.

3.4.3 Case law – specifically dealing with intellectual property or similar rights

3.4.3.1 ITC 1224 (37 SATC 30)

A taxpayer had incurred expenditure in acquiring licences for new branches (retail shops) and claimed a deduction in terms of section 11(a). The court held in *ITC 1224 (37 SATC 30)* that the licences obtained by the taxpayer created an asset of an enduring nature and that the corresponding expenditure was of a capital nature. This conclusion was not affected by the fact that the taxpayer had to renew the licences annually. The subsequent renewal expenditure will be deductible, but the initial fees paid for acquiring the licences are of a capital nature.

Although this case dealt with licence fees paid in respect of the use of physical property, its principles will also apply where licence fees are paid for the use of intellectual property (see definition of “license fees” in Chapter 1.8.3 as it relates to, eg. patented intellectual property).

The effect of this case is therefore that, if a taxpayer has entered into a licensing agreement, it is important to determine the nature of the benefits obtained by the payment of the relevant fees. A part of the fees could relate to acquisition of the right (premium) to use the property, which part should be tested for deductibility in terms of section 11(f) (see chapter 2). The agreement could further provide for the payment of regular renewal fees to afford the taxpayer the opportunity to continue using the relevant property. This part of the agreed fee could qualify for a section 11(a) deduction if all of the section's requirements are met. It follows from this court case that such payments will usually be regarded as of a non-capital nature.

3.4.3.2 *Commissioner, SARS v Kajadas Cosmetics (Pty) Ltd, 2002 (4) SA 709 (T) (64 SATC 200)*

In *Commissioner, SARS v Kajadas Cosmetics (Pty) Ltd, 2002 (4) SA 709 (T) (64 SATC 200)* the taxpayer had acquired the exclusive right to sell a product in South Africa. The initial period of the agreement was five years after which it would automatically be renewed unless it were to be terminated in accordance with the provisions of the agreement.

In terms of the agreement the taxpayer would pay an annual fee to the licensor for the distribution rights. Roux, J stated that "[w]hat is an outgoing of capital and what is an outgoing of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights".

Therefore, even though the amounts paid by the taxpayer were payable recurrently, the court held that the right to distribute the product which was paid for, was an income earning machine. The expenditure was held to be of a capital nature.

The conclusion from this view is that the mere recurrent nature of a licence fee will not necessarily classify the expenditure as of a non-capital nature. It will be important to take into account exactly what those payments secure for the taxpayer from a business point of view. Evidently the facts and circumstances will differ from one case to the next.

3.4.3.3 *ITC 1798 (68 SATC 9)*

Until the decision reached in *ITC 1798 (68 SATC 9)* royalty payments have generally been regarded as of a non-capital nature and consequently allowed as deductions, as they were seen as expenses that form part of the day to day running expenses of a taxpayer's business. It is likened to the rental paid by the taxpayer for business premises (Erasmus, 2007:8).

In this case the court decided on the deductibility (in terms of section 11(a)) of royalty payments made in terms of a trademark license agreement. Of particular importance was whether the expenditure in question was of a capital or non-capital nature.

The taxpayer (a South African company) paid royalties to its British parent company in terms of a trademark license agreement between the two companies. The payments were made for the use by the taxpayer of the trademark and licensed marketing *indicia* of its parent company.

Of importance in this case is that the taxpayer had been using these trademarks and marketing *indicia* since 1959 for free. The agreement for the payment of royalties was only concluded and applicable from 1997. The royalty amounts were based on the profit actually generated which could be attributed to the licensed marks. If the royalty agreement would ever be terminated, the taxpayer would no longer be entitled to use its trade name, which was linked to the trade mark. Another important factor is that in terms of the agreement the taxpayer was only allowed to use the licensed marks in the Republic of South Africa.

The royalties paid for 1997, 1998 and 1999 were not allowed as deductions by SARS on the basis of it being of a capital nature.

The taxpayer's arguments

According to the taxpayer, these royalty payments were of a non-capital nature for the following reasons:

- SARS had never challenged the view that royalties are of a non-capital nature and there exists a wealth of local and international authority on the subject;
- ownership of the marks vested and remained in the British parent company;
- the taxpayer obtained no enduring benefit as the contract was terminable on six months' notice;
- the payment of the royalty was repetitive and occurred annually; and
- the nature of a royalty is similar to rental, which is deductible.

The view of SARS

SARS, on the other hand, cited the following reasons for their view that the royalty payments were of a capital nature:

- the payments were made in respect of the right to operate under the name and style of the taxpayer, which enhanced and maintained the brand of the taxpayer, benefiting its income earning structure, as opposed to working it to generate profits;
- the purpose of the expenditure incurred by the taxpayer was to enable the taxpayer to retain its South African market share, name and reputation;
- the taxpayer was unable to trade without the use of the marks, which created an opportunity to earn income;
- royalty payments are no different to payments made under franchise agreements, which are capital in nature; and
- the payment of the royalty created an advantage of an enduring benefit for the taxpayer.

It was argued by SARS that the Court should enquire into the purpose of the expenditure. They referred to the case of *CIR v Genn & Co (Pty) Ltd*, 1955 (3) SA 293 (A) (20 SATC 13) where the Court held that “[i]n deciding how the expenditure should properly be regarded the Court clearly has to assess the closeness of the connection between the expenditure and the income-earning operations, having regard both to the purpose of the expenditure and to what it actually affects”.

The court’s decision

Even though Waglay, J agreed that the taxpayer did in fact pay for the use of licensed marks and marketing *indicia*, he stated that the nature and effect of the property paid for differs from mere rental in two significant respects:

- without these marks and *indicia* the taxpayer would not be able to be in a position to trade. It was argued here that the taxpayer wanted a well-established, international brand name and mark. It wanted to remain in the market as an international brand and particularly one that had a well-established market in South Africa in order to retain existing customers and attract new ones and to thus maintain and grow its market share.

Also, the use of the marks and *indicia* meant that the taxpayer did not have to incur the significant costs of re-branding itself and its product; and

- this situation is different from the landlord-tenant scenario since it cannot necessarily be said that the premises rented by a tenant are indispensable for the taxpayer's business, as it will not likely be the only premises suitable as a good trade location; and the nature of the property itself is different. A trademark is a result of the intellectual application of one's mind, and has to be specific and unique. A trademark must be distinctive and capable of being distinguished from all other marks.

A fixed asset does not need to be classified as distinctive in order to be an asset. A fixed asset on its own does not give identity to the occupant and also does not carry with it the reputation association with a product, as is the case with a trademark.

It was therefore held that the trademark gave the taxpayer structure and goodwill, without which it would be unable to continue its operations in the form and style it used to do. The rental of an asset does not give structure and goodwill to a taxpayer's business.

Also, if a lease is terminated, the tenant would be able to move to other premises, without its structure and goodwill being affected.

Waglay, J noted the taxpayer's argument that there have been no reported judgments questioning the capital or non-capital nature of such payments. However, he decided that this fact could not cause the Court to "rush to the taxpayer's aid".

A reference was also made to the Australian case of *Hallstrom Pty Ltd v FCT*, (1946) 3 AITR 436 (72 CLR 634), which held that "[w]hat is an outgoing of capital and what is an outgoing of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process." The Judge applied this test to the facts at hand and determined that the taxpayer's purpose in incurring the expenditure was to enable it to do the following:

- continue to differentiate the products it manufactured and marketed from the products marketed by its competitors under the other brand names;
- avoid the very significant costs of re-branding itself and its products;
- take advantage of the reputation which it had established over the years with the use of the licensed mark and licensed marketing *indicia* in South Africa;

- build on the reputation which it had established over the years with the use of the licensed mark and licensed marketing *indicia* in South Africa; and
- attract customers thereby maintaining and enhancing the taxpayer's profit, and maintaining and increasing the taxpayer's market share.

It was further held in *CIR v Genn & Co (Pty) Ltd*, 1955 (3) SA 293 (A) (20 SATC 13) that the fact that a payment is labelled as a royalty does not detract from the fact that it may be capital in nature. A taxpayer can therefore not structure payment for income producing structure to contain repayments in the form of "royalties" and claim that it should be deductible on that basis alone.

The court also decided that the manner in which the royalty payment was calculated, namely as a percentage of volume sold, does not automatically mean that the payment is of a non-capital nature. In the court's opinion this was merely a basis of costing the expense of the asset.

The court further held that the recurring nature of the expenditure did not detract from the expenditure's capital nature.

The court therefore held that the payments in issue were in substance a purchase price for a business which gave a substantial market share and were of a capital nature.

Du Plessis (2006:51) is of the opinion that the court's reasoning in differentiating the royalty expenditure from rental payments was unconvincing and that regard should have been given to the fact that the royalty payments did not create an enduring benefit. Although tax court cases do not constitute binding precedent, the article stated that such cases are relevant because they have persuasive power.

The decision of the tax court was overturned in the subsequent Supreme Court of Appeal case, which is discussed below.

3.4.3.4 *BP Southern Africa (Pty) Ltd v. The Commissioner for SARS, 2007 SCA 7 (RSA) (69 SATC 79)*

In *BP Southern Africa (Pty) Ltd v. The Commissioner for SARS, 2007 SCA 7 (RSA) (69 SATC 79)* the court held that the purpose of expenditure is important and often decisive in determining whether the expenditure is capital or non-capital in nature. The court referred

to the statement made in *CIR v George Forest Timber Co Ltd*, 1924 AD 516 (1 SATC 20), namely that “a distinction must be drawn between expenditure to acquire an income-producing concern and money spent in working the concern for the present production of profit”.

The court also came to the conclusion that the true nature of each transaction must be examined in order to determine the actual purpose thereof (as per the *New State Areas Ltd* case).

In deciding the true nature of a transaction, each case must be decided on its own facts and circumstances (*CIR v African Oxygen Ltd*, 1963 (1) SA 681(A) (25 SATC 67)).

The court held in *Commissioner of Customs & Excise v Randles Brothers & Hudson Ltd*, 1941 AD 369 (33 SATC 48) that royalty expenditure is deductible and in reaching this decision it took into account the following factors:

- the taxpayer obtained a non-exclusive and non-assignable authorisation to use the licensed marketing *indicia*;
- the licensor remained the sole rightful owner of the licensed marks and licensed marketing *indicia* and that all rights and goodwill attaching to or arising out of the use thereof by the taxpayer accrued to the benefit of the licensor;
- upon termination of the agreement, the taxpayer would no longer be entitled to use the said licensed marks and *indicia*;
- the brief initial duration of the agreement between the taxpayer and the licensor and the relatively short period required for termination after that initial period should be taken into account. In this regard the court referred to the decision in *Commissioner of Customs & Excise v Randles Brothers & Hudson Ltd*, 1941 AD 369 (33 SATC 48), in which it was held that the true intention of the parties to the agreement has to be established by a court through interpreting the agreement according to its tenor;
- the agreement between the parties made it clear that the royalties were paid for the use of the licensed marks and marketing *indicia*. Ownership of the intellectual property therefore remained with the licensor and after the termination of the agreement the taxpayer would automatically cease to have the right to use the intellectual property;

- the recurrent nature of the payments is a strong indicator that the expenditure is of a non-capital nature. The court here took a different view from the Tax Court by likening the royalty payments to deductible rent payments which are made for the use of assets and referred to *Turnbull v Commissioner for Inland Revenue*, 1953 (2) SA 573 (A) (18 SATC 336) in which it was stated that “rent is an expenditure incurred in the production of income and is of a non-capital nature and is therefore deductible...”; and
- the expenditure in this case neither created nor preserved any capital asset in the hands of the taxpayer. As held in *Warner Lambert SA (Pty) Ltd v Commissioner SARS*, 2003 (5) SA 344 (SCA) (65 SATC 346) this is an important factor to consider, albeit not conclusive in itself.

Taking into account the abovementioned factors, in the court's opinion the royalty expenditure was more closely connected to the taxpayer's income earning operations and therefore of a non-capital nature. The expenditure was therefore held (at 84) to be deductible in terms of section 11(a).

3.5 ROYALTIES PAID IN THE FORM OF FRANCHISE FEES

According to Erasmus (2007:5) it is important to look at the contractual relationship (franchise agreement) between the franchisor and franchisee to determine what rights are conferred to the franchisee.

It is further argued by Erasmus (2007:6-7) that the franchise agreement could provide for the payment of the following types of fees:

- an initial start-up fee payable for the exclusive use area. This fee would be of a capital nature, as it creates an income-producing structure. It will also not qualify for the section 11(f) deduction, as it is not incurred for the right of use of any asset;
- an initial start-up fee payable for the right to use the intellectual property which belongs to the franchisor. Examples of this type of property could include trade marks, trade names, patents, copyrights, designs, software and know-how. This payment secures the right to use the intellectual property and is not for the actual use of the property. This part of the franchise fee could qualify for the section 11(f) deduction; and

- on-going fees payable to maintain the use of the exclusive use area and the intellectual property (in the form of royalties). The deductibility of these royalty amounts was brought into doubt by *ITC 1798*, although the subsequent Supreme Court of Appeal decision provided more certainty.

In order to establish the exact tax consequences of a franchise agreement, it will be important to determine:

- the true intention of the parties;
- the split between the initial fees (both for the right of use of the property as well as the fee for the exclusive use area) and the recurring monthly/annual fees and how this split was calculated; and
- how the various "rights" that are transferred, are described.

In order to ensure that the relevant deductions are available to the franchisee, the franchise agreement must clearly and precisely describe what the fees and rights are that form the basis of the agreement (Erasmus, 2007:14)

If a taxpayer pays an amount to the owner of intellectual property for the cancellation of an agreement, that amount will not be a premium which can qualify for the section 11(f) deduction, as it is not paid for the right of use of the property. The taxpayer may seek a deduction of such amount in terms of section 11(a) if all of the requirements are met. However, in *Seeff Properties CC v CIR*, 1998 (5) JTLR 128 (60 SATC 407) it was held that an amount paid by a franchisee to a franchisor for early termination of a franchising agreement was of a capital nature because it was closely related to establishing an income generating structure for the taxpayer. In this case the taxpayer ended the agreement in order to be able to trade in his own name. In terms of this court case, payments of this nature will therefore also not be deductible in terms of section 11(a).

3.6 CONCLUSION

If it is established that payments made for intellectual property (eg. royalties paid) by a taxpayer do not qualify for a specific deduction, the taxpayer may need to seek a deduction in terms of section 11(a). The following important factors flowing from the cases discussed in this chapter are applicable to such payments:

- it has to be determined, by taking into account the surrounding facts and circumstances, whether the payments represent the purchase of a part of the income-producing structure of the business (for example the right to use intellectual property exclusively in a designated area) or whether it is merely incurred in working the profits of the business (for example royalties paid on a recurring basis for the continued use of intellectual property);
- if ownership of the intellectual property is not transferred as a result of the payments, it may indicate that the payments are not of a capital nature, as they may be regarded as similar to rent payments made. This will also be reinforced if it is clear that the taxpayer will lose their right to use the property at the end of the term of the relevant agreement;
- the recurring nature of some payments may lead to the conclusion that they are not of a capital nature. However, even if the payments recur regularly (for example annually) the expenditure can still be regarded as capital in nature, if the underlying circumstances indicate that these payments establish an enduring benefit for the taxpayer;
- even if the payment is done as a lump sum, the expenditure may still be regarded as revenue in nature;
- the length of the term of the agreement in terms of which the payments are made needs to be considered. A relatively shorter period could support a contention that the payments are of a non-capital nature; and
- the basis on which the fees are calculated (for example as a percentage of sales) could be an indication of the capital or non-capital nature of the payments.

All of the factors surrounding the taxpayer's specific circumstances must be considered. As none of the abovementioned factors are conclusive on their own, the case law has indicated that they must all be taken into account in the context of the rights and privileges enjoyed by the taxpayer.

CHAPTER 4

CONCLUSION

4.1 INTRODUCTION

The purpose of this study was to provide certainty to taxpayers and other interested parties with regard to the deductibility of payments made for intellectual property in whichever way these payments may be structured.

Deductions for such payments have to be claimed in terms of section 11 of the Act. The first requirement of section 11 is that the taxpayer must be carrying on a trade and earning income from that trade, in order to deduct amounts against that income.

It must be borne in mind that the onus of proof that a taxpayer should be allowed a deduction in terms of the Act, is on the taxpayer. Therefore, the taxpayer needs to prove that a trade was being carried on when the relevant intellectual property expenses were incurred. Certain expenses in respect of intellectual property incurred before trading commences, may be deducted as soon as the taxpayer starts trading, if the requirements of section 11A are met.

Once the taxpayer has satisfied the trade (or pre-trade) requirement of the Act, the taxpayer must determine whether an expense qualifies for deduction in terms of a specific deduction section contained in the Act. If no such deduction exists, the taxpayer needs to consider whether the expense may be deducted in terms of the general deduction formula contained in section 11(a).

4.2 RESEARCH OBJECTIVES

The research objectives of this study were to

- identify the provisions of the Act that specifically provide for the deduction of payments made for intellectual property. This was discussed in chapter two;
- identify the factors that need to be considered in determining whether a payment made in relation to intellectual property qualifies for any of the specific deductions provided in the Act. This was done in chapter two through the analysis of the provisions of the Act and any relevant recent court cases which have dealt with the interpretation of those sections;

- identify the factors that need to be taken into account in determining whether a payment made in respect of intellectual property that does not qualify for any of the specific deductions mentioned above, will qualify for a deduction in terms of section 11(a). This was done in chapter three; and
- design a flow diagram that will assist a taxpayer in determining whether a payment made in respect of intellectual property will qualify for a deduction against its income, either in terms of a specific deduction, or alternatively, in terms of section 11(a). This flow diagram is provided at the end of this chapter as part of the final conclusion.

4.2 SPECIFIC DEDUCTIONS

In order for specific deductions to be claimed by a taxpayer, the taxpayer must use the relevant intellectual property items in the production of income.

The extent and timing of the specific deductions depend on the nature of the payments made by the taxpayer.

If a taxpayer purchases a patent, invention, design or copyright, the taxpayer may qualify for a deduction in terms of section 11(gC). The purchase price can be claimed over 20 years (10 years in the case of a design). No deduction is allowed for the purchase of trade marks.

Taxpayers need to incur expenses for the registration and afterwards, the renewal of registration, of their intellectual property items. These expenses may qualify for a full once-off deduction in the year in which they are incurred in terms of section 11(gB).

It may happen that a taxpayer does not acquire the intellectual property items, but merely pays a premium for the right to use such property for a certain period of time. In such a case the taxpayer may qualify for a deduction in terms of section 11(f). The deduction of the cost of the premium will be spread and claimed over the useful life of the relevant intellectual property item. No deduction will be allowed if the premium is not included in the income of the person receiving the premium.

Section 23I is applicable when the taxpayer incurs expenditure in respect of “tainted” intellectual property, where payments for such property are not included in the income of the recipient. Where section 11(f) would disallow the deduction of premiums paid to such recipients, section 23I will disallow other such payments (such as royalty payments which would otherwise be deductible in terms of section 11(a)).

Another specific section to take into account is section 35, which determines that a taxpayer who pays royalties or premiums to non-residents, must withhold tax at 12% from the payment to the non-resident. The taxpayer is personally responsible for the payment of the tax, so it is vital to know all of the sections requirements.

Research and development expenditure incurred by a taxpayer in respect of their own intellectual property may qualify for deduction in terms of section 11D of the Act. This section encourages taxpayers to undertake research activities by providing for 150 per cent of operational research expenses to be deducted, while capital assets utilised in the research process may qualify for accelerated wear and tear allowances. This is assuming that the taxpayer meets all the other requirements of section 11D.

The taxpayer may also seek a deduction for registration and renewal costs in respect of intellectual property items developed by the taxpayer in terms of section 11(gB).

The effect of section 23B also needs to be considered, as it determines that amounts which may qualify for deduction in terms of more than one section may not be deducted more than once. An important further consequence of this section is that if an amount is paid in respect of expenditure provided for by a specific section, but it is prohibited from being deducted by any of the requirements of that section, the taxpayer may not seek a deduction in terms of section 11(a).

4.3 GENERAL DEDUCTION FORMULA

Where payments are made for the use of intellectual property (such as royalties or license fees paid) there will be no specific deduction available for the deduction of the expenditure incurred.

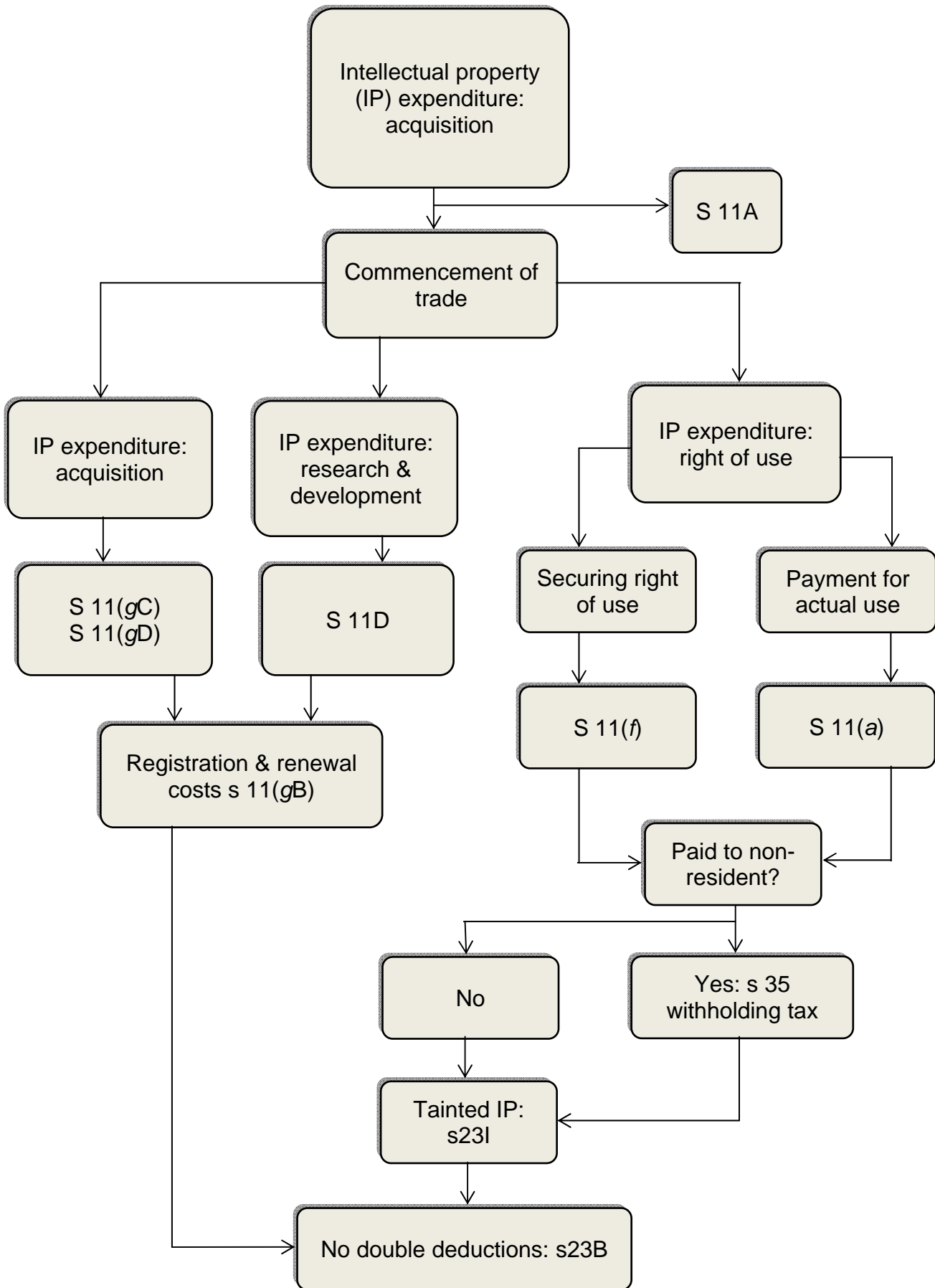
The taxpayer will seek a deduction for such payments in terms of section 11(a). The main problem is whether such payments are of a capital or non-capital nature. In cases where the payments secure an enduring benefit for the taxpayer and subsequently relate to the

income generating structure of the taxpayer (usually initial, once-off payments), they will be held to be of a capital nature and not deductible. If they are of a recurring nature and merely relate to the use of the intellectual property while no transfer of ownership takes place, they could be regarded as of a non-capital nature and deductible.

4.4 CONCLUSION

Figure 2 below provides a summary of the process to follow in determining which sections of the Act should be considered when claiming a deduction for intellectual property payments. This should serve as a guideline to eliminate the uncertainties faced by a taxpayer and identified as the research problem of this study.

Figure 2: Process of identifying applicable sections



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