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Abstract

This article examines the royalty provisions of South Africa's double taxation agreements in the light of certain emerging issues relating to the tax treatment of the transfer of technology worldwide.

The experience of both Australian and United States tax practices in these areas is drawn upon, as well as the provisions of the 1992 OECD Model Tax Convention, in an attempt to make suggestions for the reform of South Africa's international tax policies at this crucial stage in its development.

Keywords

South Africa, tax, reform, international tax

SOUTH AFRICAN DOUBLE TAX TREATIES: ROYALTY REFORM IN THE LIGHT OF THE AUSTRALIAN EXPERIENCE

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This Article examines the royalty provisions of South Africa's double taxation agreements in the light of certain emerging issues relating to the tax treatment of the transfer of technology worldwide.

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When countries from Algeria to Zimbabwe in the space of a few years, and not under the pressures of war, find it necessary to talk of the need to change their tax systems, it is also necessary for observers to question and ponder. Not least must they ponder why it is that politicians consider it worth their while to talk about taxation at all. The whole of recorded history evidences the political opprobrium to be earned by the imposition of unpopular taxes and adds to it the rider that, bar exceptional circumstances, taxes are, almost by definition, unpopular. For this simple reason, the cliché that "an old tax is a good tax" suggests that a new tax is the converse.¹

1 Introduction

The reconstruction of the world economy after the Second World War has brought in its wake a move towards the globalisation of economic activity, with the removal of trade and investment barriers and the increasing deregulation of financial systems. A simultaneous improvement in international communications and transportation has further contributed towards the growth in the export of goods, services, capital and technology. GATT (General

¹ Williams D, *Trends in International Taxation* (1991) para 100.

(1995) 5 Revenue L J

Agreement on Tariffs and Trade) and World Bank figures both demonstrate that the international trade of states is growing faster than national GDPs.²

A corollary to this liberalisation of world trade has been a rise in fiscal interdependence. As transactions that span national boundaries become more commonplace, so attention has become focussed on the cross-border ramifications of national tax policies. While there has been a move towards general commercial co-operation and harmonisation, there are still enormous cross-country differences, not only in relation to the rate at which transactions are taxed, but also as regards the basis on which taxes are levied. There is a:

growing sense that the internationalisation of financial markets and the increased importance of multinational enterprises are making it increasingly difficult to administer and enforce efficient and equitable income tax systems. Tax authorities must balance, on the one hand, their desire to preserve their national revenues and, on the other hand, their own unwillingness to harm the international competitiveness of their domestic business interests. Thus there is not only a heightened international competition among business but also heightened awareness of the possibilities and perils of international fiscal competition.³

It is against this worldwide background of a search for fiscal policies which will be effective in a rapidly evolving global marketplace that a dramatic change in South Africa's political, social and economic character has taken place, resulting in an increasingly open and flexible environment internationally. The realisation that a thorough review of the tax system should be undertaken, in view of the fundamental changes which are reshaping the South African polity and economy, led to the appointment of a Commission of Inquiry into certain aspects of the tax structure in June 1994. This Commission has had "to take cognisance of both the dynamics of South Africa's evolution to a new social and economic order and the rapidly changing world context within which South Africa's renaissance is occurring".⁴

As a developing country which has only recently rejoined the international community, South Africa needs to re-appraise, review

² Ibid at para 175.

³ Razin A and Slemrod J (eds), *Taxation in the Global Economy* (1990) 2.

⁴ *Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* (1994) para 1.4.1.

and reform both the domestic and international aspects of its tax policies and, in particular, its outdated tax agreements with other countries.

One of the fastest growing and most important areas of world trade which South Africa must take into account is the transfer of technology.

By almost any measure - monetary or non-monetary - the globalisation of trade and the transfer of technology over the past twenty-five years have improved the quality of life for billions of people, especially the 2.4 billion inhabitants of countries the World Bank classifies as "low-income economies".⁵

Transactions relating to the transfer of technology are extremely sensitive to variances in their tax treatment between countries, especially between developed and developing nations. A key element of such transactions is the treatment of royalties under double taxation treaties.⁶

This article examines current issues relating to the royalty provisions in double taxation agreements (DTAs) and, at the risk of earning the opprobrium referred to above, makes recommendations as to how these issues should be dealt with in the context of South African treaty reform. These current issues will also be evaluated in the light of the Australian experience with regard to the royalty provisions in its DTAs, in order to provide a developed country perspective.

To provide a background to the tax treatment of royalties in DTAs, I begin by discussing the development of tax treaties, looking at the tax treaty networks and the jurisdictional bases of taxation in both Australia and South Africa. I will then review three of the current issues affecting the tax treatment of royalties: the meaning of royalties in relation to software, treaty shopping and transfer pricing. Where relevant, I will draw on the United States tax experience, as:

the relative importance of the US tax system is apparent even from a vantage point free of ethnocentricity. The

⁵ Wendt H, *Global Embrace* (1993) 264.

⁶ Other treaty provisions which may impact on the transfer of intellectual property include, inter alia, the business profits, capital gains and permanent establishment articles, and articles dealing with dependent and independent personal services.

(1995) 5 Revenue L J

United States is the single largest national economy and the single largest market for the world's goods and investment, as well as a source of exports and investments in other markets. A significant proportion of the world's acquisitive transactions is therefore affected in some way by US taxation.⁷

2 The development of double taxation treaties

International double taxation can be described as "the result of the assertion of jurisdiction to tax a particular taxpayer or item of income by two (or more) sovereign states."⁸ Although double taxation began to be perceived as a serious obstacle to international trade after the introduction of the direct taxation of business profits in the early twentieth century and especially after the rise in rates after 1914, relatively few income tax treaties were in force prior to the Second World War.⁹ Nevertheless, even at this early stage, it was perceived that if, for example, the same property was taxed more than once at a high rate, this would result in its virtual confiscation by the revenue authorities.

In the postwar period, the International Chamber of Commerce (ICC), acting as a representative of the international business lobby, encouraged the idea of a multilateral double tax convention to facilitate international investment. The original aim was to harmonise the systems of business taxation in developed countries, thereby implementing a tax-neutral set of rules which would have no impact on, or which would not motivate, business decisions. However, the Fiscal Committee that had been established by the Organisation for Economic Co-operation and Development (OECD) for the task of preparing the draft convention, found the aims of universality and uniformity to be inapplicable in practice. Instead, drafts which permitted alternative applications suited to the varying concerns of divergent national tax systems were formulated. These were eventually consolidated, and in 1963 a draft Double Taxation Convention on Income and Capital was published by the OECD.¹⁰ This Model Income Tax Convention was revised in 1977 and 1992, and forms the foundation for the bilateral negotiation of double taxation treaties, especially between developed countries.

⁷ Isenbergh J, Vol 1 *International Taxation: US Taxation of Foreign Taxpayers and Foreign Income* (1990) 8.

⁸ Hamilton R and Deutsch RL, *Understanding Australian International Taxation* (2nd ed 1988) para 601.

⁹ Piciotto S, *International Business Taxation* (1992) 1.

¹⁰ *Ibid* at 52-53.

Some members of the OECD have developed their own models for negotiation, although these models are themselves based largely on the 1977 OECD Model. Examples of these are the United States Treasury Model of 1981 and the Netherlands Model of 1988. The United Nations also used the OECD 1963 and 1977 Drafts in its preparation of the UN Model Double Taxation Convention between Developed and Developing Countries of 1980.

The need for a treaty specifically geared to developing countries arose out of the increase in the number of independent states in Asia and Africa in the 1960s and 1970s. Attempts to extend the tax treaty network to these developing countries had largely been in vain up to this point, except where treaties had been negotiated on their behalf by their colonial mother-countries, especially Britain.¹¹ These developing countries all had a pressing need for infusions of capital and technology and, consequently, felt that the OECD Model, with its emphasis on exclusive rights to tax being granted to the state of residence, was inappropriate to their needs. The UN Model can be seen as a compromise between the "residence" and "source" bases of taxation:

in particular, the UN Group determined that, [with] respect to interest, dividend and royalty income, developing nations should relax their source basis taxation orientation while the developed countries should relax their orientation toward residence basis taxation.¹²

The ultimate difference between the OECD Model and the UN Group Model is that the latter assigns a greater role to source state taxation in relation to certain business activities. However, one should not see these Models as offering widely divergent viewpoints - they may be regarded as variations on a theme. The UN Group Model made minor modifications on some dozen points, including an amendment stating that royalties "may be taxed"¹³ in the state of residence of the beneficial owner, thus allowing scope for royalties to be taxed in the source state. This can be contrasted to the OECD

¹¹ Ibid at 55. An example of this is the DTA between South Africa and Lesotho, which is in fact an agreement entered into between the South African government and the government of Great Britain and Northern Ireland in 1959.

¹² Koch TD, "Current United States Tax Treaty Policy with Developing Countries - The Need For A United States-Developing Country Model Income Tax Treaty" 7 (Winter 1983) *ASILS International Law Journal* 144.

¹³ Article 12(1) of the UN Model Treaty.

(1995) 5 Revenue L J

Model which states that royalties shall be taxable only in the state of residence of the beneficial owner. The UN Group Model also makes provision for a withholding tax on royalties, at a rate to be negotiated between the parties.¹⁴ However, the UN Model Treaty is merely an adaptation of the 1963 OECD draft and cannot be regarded as a new departure in the approach to tax treaties.¹⁵ As it is, the terms of model treaties are always adapted and modified to suit the particular needs of the treaty partners involved, so that no two treaties are ever identical. Thus the terms of the OECD Model treaty and their periodic revisions remain the basis on which countries negotiate double taxation treaties with their trading partners. Although developing countries do not regard any model treaty as adequately reflecting their needs and interests, they are compelled to expand their tax treaty network in order to achieve an inward flow of foreign investment and technology. They realise that a balance must be achieved between seeking revenue and encouraging investment.

DTAs are a unique combination of the elements of the taxation concerns of the two countries involved. As such, they create an international tax regime which may be quite different from the domestic tax regime of either country, and which will apply only between the treaty partners concerned.

Two main policy considerations are considered by governments when drafting royalty provisions for their double taxation treaties, namely: (i) the protection of the revenue yield from taxes on royalties, and (ii) the maintenance of a tax climate conducive to inward flows of technology. These considerations must be carefully balanced, so that an equilibrium can be achieved, "between protecting the tax system against gross excess, and not seeking to throw a net so tightly that the measures become a disincentive for legitimate business".¹⁶

The specific provisions of double taxation treaties uniquely reflect the profile of the trade and investment flows between the two countries, as well as their respective bargaining powers. As far as transactions concerning transfers of intellectual property involving the payment of royalties are concerned,

countries that are importers of technology and capital will generally seek to obtain terms in treaties that leave the

¹⁴ Article 12(2) of the UN Model Treaty.

¹⁵ Piciotto, above n 9 at 56.

¹⁶ Interim Report, above n 4 at para 14.6.22.

taxation of royalties and license fees in the country of source. Countries that are exporters of capital and technology will prefer taxation by the country of residence of the owner of the capital or technology.¹⁷

In the past, countries such as the United States, which favour the OECD Model treaty terms, have advocated the deferral of the right of the country of source to tax royalties to the country of residence. In other words, royalties are taxed solely in the state of residence of the beneficial owner of the royalties. Developing countries, on the other hand, often seek to tax royalties at source, as they are usually importers of technology from developed nations. They therefore favour the UN Model, which specifically makes provision for the taxation of royalties in the state of source. Although there is a realisation that entering into a tax treaty with a developed country will open doors to both economic and technological development, there is a concern among developing countries that the offering of tax incentives designed to attract such foreign capital and technology may result in severe revenue losses. However, a tax treaty uniquely crafted according to the needs of each treaty partner can balance the interests of the parties and provide an appropriate vehicle for advancing their respective foreign economic policies.

3 Australia and South Africa: the contrast between a developed and a developing country

3.1 General

Although South Africa is still a developing country according to the United Nations' definition, it is the most highly developed country on the African continent.¹⁸ It has been identified as the economic powerhouse of Southern Africa - a region of 12 countries with a population of about 100 million and occupying an area roughly the equivalent of Western Europe. South Africa alone accounts for around 80% of the gross national product of this region.¹⁹ It is

¹⁷ Isenbergh J, Vol II *International Taxation: US Taxation of Foreign Taxpayers and Foreign Income* (1990) 318.

¹⁸ Although South Africa accounts for only 4% of Africa's surface area and 6.5% of its population, the country is credited with 20% of the continent's gross national product, 40% of its industrial output, 45% of mining production, 66% of all steel consumption and electricity generated, 45% of its motor vehicles and 37% of its telephones. Sout African Bureau of Information, *This is South Africa* (1988) 1.

¹⁹ Ibid.

(1995) 5 Revenue L J

categorised as an industrialised country by the International Monetary Fund (IMF) and as a developing country by GATT.

Trade with foreign countries has always played an important part in the South African economy but, in the past decade, trade and financial sanctions against South Africa have inhibited the movement of capital into and out of the country. Consequently, the promotion of "a tax system conducive to an influx of capital has not been of primary importance."²⁰ However, in the light of recent political changes, and of the abolition of sanctions, it now "becomes increasingly attractive to structure the tax system in a way that will make South Africa attractive to foreign investors."²¹

Australia, in turn, is defined as a developed country by the United Nations and GATT. It has a number of characteristics which make it attractive to foreign investors, including:

its natural resources, political stability, the affluence of its growing population, its skilled labour force, geographical location to other large markets, the integrity and comparative efficiency of its bureaucracy, the relative freedom from economic controls, and its "open door" attitude to foreign investment.²²

Figures derived from the Australian Bureau of Standards indicate that Australia has a very high concentration of foreign investment, and the current government economic policy indicates a continuing dependence on foreign investment for development.²³ In this respect it is similar to South Africa.

3.2 The tax treaty networks of Australia and South Africa

Australia began signing DTAs in the late 1960s, and continued to enter treaties in the 1970s, 1980s and 1990s, with the latest treaties being signed in 1992 with Indonesia and Vietnam. To date, Australia has more than 30 comprehensive treaties with Asian, European and North American countries.²⁴ Australia's DTAs are

²⁰ Boshoff V, "Corporate Tax Rates and Inter-Country Comparisons" (1993) 61 *The South African Journal of Economics* 301.

²¹ Ibid.

²² Hamilton and Deutsch, above n 8 at para 101.

²³ Ibid.

²⁴ Comprehensive treaties are those which extend to a number of different types of income and not merely to aircraft and/or shipping business.

patterned on the OECD Models of 1963 and 1977,²⁵ and at present the 1977 OECD Model Convention and its Official Commentaries are relevant for the interpretation of Australian tax treaties.²⁶ Australia is a member of the OECD and a party to the Vienna Convention on the Law of Treaties.

Australian DTAs enjoy the status of paramountcy, as, according to s 4(2) of the Income Tax (International Agreements) Act 1953, the provisions of the treaties will prevail over the provisions of the ITAA in cases of inconsistency (other than s 160AO or Part IVA of that Act).

South Africa has entered into far fewer comprehensive DTAs than Australia. Its treaties were concluded in the 1940s-1970s - the last treaty to be entered into being with the Ciskei in 1982. The treaty with Canada was abrogated by the Canadian government in 1986 and the treaty with the United States was abrogated by the US government in 1987. With the recent re-incorporation of the TBVC States (Transkei, Bophuthatswana, Venda and Ciskei), it might safely be assumed that the treaties with these former States have fallen away.²⁷ South Africa's comprehensive DTAs are presently with a few European and African countries, and with Israel. There is no DTA between South Africa and Australia.

In terms of s 108 of the South African Income Tax Act No 58 of 1962, the State President is empowered to enter into agreements with the government of any other country or territory for the prevention, mitigation or discontinuance of the levy of tax by both governments in respect of the same income. The arrangements provided for in the treaty must be notified by proclamation by the State President in the Government Gazette. This Proclamation has the effect, until the revocation of the proclamation, of giving the terms of the agreement the same effect as if they had been enacted in the domestic Income Tax Act. There is therefore no "paramountcy" provision for South Africa's DTAs.

²⁵ Grbich Y, Bradbrook AJ and Pose K, *Revenue Law - Cases and Materials* (1990) 782.

²⁶ Lehmann G and Coleman C, *Taxation Law in Australia* (3rd ed 1994) 971.

²⁷ The Interim Report states at para 14.7.2: "The problems surrounding the reintegration of the former States of Transkei, Bophuthatswana, Venda and Ciskei into the South African tax system are currently being investigated by the responsible revenue authorities. The Commission urges that this issue should be resolved promptly in view of the undesirable consequences of continued uncertainty for business investment in these areas and in view of the revenue losses associated with the present anomalous position in several regions."

(1995) 5 Revenue L J

Many of South Africa's treaties were entered into more than 30 years ago, and have not been updated since. This gives rise to the situation where, for example, the agreements entered into by the Union of South Africa (before it became a Republic in 1961) and the Federation of Rhodesia and Nyasaland, and between the Union and Kenya, Tanganyika, Uganda and Zanzibar, in practice appear to be regarded as continuing in force between the Republic and Zambia and the Republic and Tanzania and Uganda respectively.²⁸

South Africa has adopted the wording of the OECD 1963 Model Tax Convention in its treaties with developed countries - Germany, the Netherlands, Switzerland and the United Kingdom - while tending towards the UN Group's approach in treaties with Botswana, Malawi, Swaziland and Zimbabwe. One explanation for this inconsistent approach could perhaps be that South Africa assumed different roles in respect of the foreign countries concerned, ie that of either a developing or developed country relative to the treaty partner state.²⁹ South Africa is not at this stage an OECD member, or a signatory to the Vienna Convention on Treaties.

As South Africa has re-established trade relations with many of its former trading partners, it can now expect to expand the number of its double taxation treaties. President Clinton has announced that the US will shortly enter into negotiations with South Africa for the purpose of concluding a DTA.³⁰ This is therefore an opportune time for South Africa to re-examine its treaty structure in the light of recent developments and changes in Model Tax Conventions.

3.3 Jurisdictional bases of taxation

The jurisdictional bases of taxation used by a country are an important indicator of the stage of "development" it has reached. Developing countries tend to utilise source as the main basis of taxation, as they seek to maintain a share of any income generated within their borders. Developed countries, on the other hand, tend to utilise residence as a basis of taxation. This is rationalised on the grounds that the state which provides certain privileges and

²⁸ Divaris C and Stein ML, Vol II *Silke on South African Income Tax* (11th memorial ed 1989) para 24.20.

²⁹ Eskinazi R, "Interpretation of Double Taxation Agreements - A South African Perspective" (1993) 6 SA Tax Review 129.

³⁰ Ibid at 127.

protection to its residents is entitled to a share of their income, regardless of where it may have been generated.

Developing countries therefore place emphasis on wealth produced within their borders by virtue of its natural resources or the activities of its inhabitants, regardless of where they reside, while developed countries place a premium on the wealth produced by its skilled residents.

Australia's jurisdictional bases of taxation are the residence of the taxpayer and the source of income. Section 25(1) of the Australian Income Tax Assessment Act 1936 (ITAA) sets out the rules in relation to the taxation of the gross income of residents and non-residents as follows:

the assessable income of a taxpayer shall include -

- (a) where the taxpayer is a resident the gross income derived directly or indirectly from all sources whether in or out of Australia; and
- (b) where the taxpayer is a non-resident the gross income derived directly from all sources in Australia.

Australia thus taxes its residents on a worldwide basis (ie it taxes their income irrespective of its source), but taxes non-residents only on income which is sourced in Australia.

This approach lies in direct contrast to the South African domestic tax system, which taxes almost exclusively on the basis of source. Apart from a few specific exceptions, residence is not utilised as a basis for taxation. The definition of "gross income" in the South African Income Tax Act No 58 of 1962 refers specifically to income: "from a source within or deemed to be within the Republic."

This divergence of tax bases illustrates the difference between South Africa as a developing nation and Australia as a developed nation. Developed countries tend to be capital-exporting (as has been the case with the United States), and emphasise the taxation of residents on income from all sources. Developing countries tend to be capital-importing and emphasise the source principle. The attitude of developed countries is reflected in the US Model Treaty which disallows source state taxation of interest, royalties and business profits unless these items are attributable to a permanent establishment (fixed base). The favouring of a larger taxing role for the source state by capital-importing countries is reflected in the UN Model Treaty, which was heavily influenced by developing

(1995) 5 Revenue L J

countries. This Model permits source state taxation of interest and royalties that are not attributable to a permanent establishment.³¹

The recent *Interim Report of the Commission of Inquiry into certain aspects of the Tax Structure of South Africa* (Interim Report) discussed the issue of the adoption of a world-wide (ie residence-based) tax system.³² It was argued that an absence of exchange controls (presently under consideration) would inevitably require such a change to be made to the tax base. However, the Commission concluded that:

any change as fundamental as moving onto a world-wide system will imply an immense administrative and technical challenge to an administration which, as elsewhere discussed in this Report, is already dangerously stretched.³³

In this context, it is interesting to note in the comments of American legal writers a return to more favourable attitudes to source rules, in light of the changing economic position of the US in the global marketplace. H David Rosenbloom states in this regard:

whether the time is appropriate for the United States to move past the OECD in the direction of correcting its traditional bias against source basis taxation is another matter. The prime targets would presumably be the royalty article, where the present position calls for exemption and, more symbolically, the other income article, where our model calls for exclusive residence taxation.³⁴

³¹ Doernberg RL, "The U.S.-India Income Tax Treaty: Breaking New Ground In Taxing Services Income from Licensing Technology" 44 (Spring 1991) *Tax Lawyer* 738.

³² Signed on 18 November 1994.

³³ At para 14.6.5.

³⁴ Rosenbloom HD, "Towards a New Tax Treaty Policy for a New Decade" 9 (Spring 91) *American Journal of Tax Policy* 90.

4 The tax treatment of royalties: current issues

There are a number of issues currently generating interest in relation to the tax treatment of royalties. There has been a growing concern that royalty provisions are being utilised to permit “treaty shopping” and “transfer pricing”, and there has been a continuing debate concerning the tax treatment of software. These issues were all considered by the OECD in the formulation of its 1992 draft, and they affect both developing and developed countries, although to different degrees.

In looking to the amendment of DTA provisions dealing with royalties in the light of these recent developments, a developing country - such as South Africa - should give consideration to the overall impact of any changes which could be made. The merits of introducing anti-tax avoidance measures must be carefully considered, having due regard to the type of conduct they are seeking to prevent, as well as to the administrative capacity of the fiscal infrastructure to implement such measures.

4.1 The meaning of royalties in relation to software

Article 12(2) of the 1992 OECD Model Convention provides:

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

The 1992 Draft amends the 1977 Draft by deleting the following words:

or for the use of, or the right to use, industrial, commercial or scientific equipment.

Jacques Sasseville of the Fiscal Affairs Division of the OECD comments that:

This change, which has been recommend[ed] in the 1983 report on the *Taxation of Income Derived from Industrial, Commercial or Scientific Equipment* results in the income from the leasing of such equipment falling under Article 7 (Business Profits) rather than under Article 12. Thus, such rental income will avoid withholding taxes on royalties

(1995) 5 Revenue L J

where countries do not adhere to the OECD formulation of Article 12. It should be noted, however, that a large number of Member Countries have made reservations indicating that they wished to continue using the previous definition of "royalties".³⁵

Although Article 12 makes no specific reference to the way in which computer software will be dealt with under the royalties definition, this is an issue which has attracted a great deal of attention. The Business and Industry Advisory Committee (BIAC) to the OECD submitted a position paper to the OECD Fiscal Committee recommending that:

1. Where software is eligible for protection under the copyright law of the country in which it was developed, payments for the use of such software in the source country shall be classified as Copyright royalties;
2. Payments for software not eligible for other protection will constitute business profits under Article 7, the taxability of which would depend upon the existence of a permanent establishment in the source country.³⁶

Whether or not computer software is protected by a country's copyright law is a question for each country's domestic legislation. The BIAC's findings were that:

the OECD Model Treaty offers adequate opportunities for the encouragement of software activities, although in several bilateral situations the tax treatments applied to these activities were confused and inconsistent, and that an inordinate expenditure of time and money had been necessary to the taxpayers involved to defend and settle their positions.³⁷

The BIAC concluded by suggesting that:

the form of software payments should not be determinative of their tax treatment, but that this should be dictated by their fundamental economic characteristics, as there may be a transaction in goods, in services, in intellectual property, or in all three combined.³⁸

³⁵ Sasseville J, "The New Model Tax Convention" (1993) 6 SA Tax Review 119.

³⁶ Ibid at 124.

³⁷ "Tax Treatment of Computer Software" LXIIIb (deuxieme sujet 1988) *Cahiers de Droit Fiscal International* 35-36.

³⁸ Ibid.

A report by the International Fiscal Association refers to difficulties in applying the “permanent establishment” definition to software sales, and in the application of withholding tax to software royalties. Because the development costs incurred in relation to software are often very high, a withholding tax on gross royalties may make substantial inroads into the net profit element in software sales or licensing.³⁹

The 1992 OECD Commentary discussed the application of tax conventions to payments relating to software, especially as to whether such payments could qualify as royalties. The conclusion drawn was that, in most instances, the payments would fall under the provisions of another Article of the Model Treaty, rather than under Article 12. For example, payments in consideration for the acquisition of software for the personal or business use of the acquirer, regardless of whether there are restrictions on its use, will usually constitute business profits (Article 7), or income from independent services (Article 14), rather than royalties.⁴⁰ Where payments are made under mixed contracts (where sales of computer hardware with built-in software are made, or services are provided along with a concession of the right to use software), the recommendation is that:

where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.⁴¹

No changes to the text of the Model Convention were felt to be required.

It should be noted that a great deal of dispute arose between OECD Member countries regarding the tax treatment of software, and the issue cannot be said to have been resolved. Australia was one of the countries to enter reservations to the 1992 Article. It was, *inter alia*, “reluctant to accept that payments for software acquired for personal or business use do not represent royalties”.⁴²

³⁹ Baker P, *Double Tax Agreements and International Tax Law: A Manual* (1991) 205.

⁴⁰ Sasseville, above n 35 at 124.

⁴¹ Ibid.

⁴² McNab P, “OECD Tax Model: Software Bits” 2 *Taxation in Australia Red Edition* 97.

(1995) 5 Revenue L J

As the debate concerning the treatment of computer software continues, it does not appear likely that a uniform interpretation will be devised and included in a future draft of Article 12. None of the South African or Australian treaties make any specific reference to the tax treatment of software in the royalty provisions of their DTAs and, as far as South Africa is concerned, the issue does not seem to have received much attention. Perhaps the best recommendation that can be made in relation to the tax treatment of software is that a pragmatic approach should be adopted. What is needed is a flexibility in the application of existing definitions to accommodate the increasing sophistication in computer-related technology, as there is a continuing problem of "the pace of development in the commercial world outstripping the development of appropriate legislation".⁴³

Setting aside the issue of software, the definition given to the term "royalties" in the 1992 OECD Model Convention at Article 12(2) is one which South Africa would be well-advised to adopt, as it is clear, precise and brief - although admittedly not exhaustive.⁴⁴ The trend in defining what constitutes a royalty is towards extremely lengthy descriptions, whereby states seek to cover every eventuality. While this can in part be understood, there is an equally understandable call for simplicity, clarity and brevity - although a combination of all these attributes would be difficult to achieve.⁴⁵ The advantage of adopting this definition both for extant treaties and those to be entered into in the future is that the standardisation of exactly what is included under the term "royalties" would give South Africa's treaties a certainty which they do not possess under the present treaty regime. Such certainty could only act as an encouragement to investors in treaty partner countries, who would no longer have to speculate how their technology-related transaction would be dealt with by the South African revenue authorities.

⁴³ "Tax Treatment of Computer Software", above n 37 at 43.

⁴⁴ Baker, above n 39 at 199.

⁴⁵ This dilemma is summed up by Williams (above n 1 at para 166) in referring to trends in international taxation:

How is simplicity achieved? One test is itself simple: weigh the text of the national laws - the lighter the better; there is less to understand, get wrong, administer, etc. Another test is to reduce administrators' decisions, and therefore the number of administrators. A third - though one less likely to be attempted - is to make the laws more comprehensible to the average taxpayer. A fourth is to leave less room for argument by taxpayers about intent and meaning.

The incorporation of the OECD definition of royalties into South Africa's domestic royalty provisions (which do not at present coincide with the various treaty definitions) would further extend this certainty to investors from non-treaty countries, although these would of course have to pay a much higher rate of withholding tax than a treaty resident. Although the definitions given to royalties in Australia's tax treaties are not identical, the definition applied in the later treaties largely coincides with the definition of a royalty under s 6(1) of the domestic ITAA.

This harmonisation of domestic and international definitions ensures a certainty and stability which is attractive to investors, and which leads to a climate of business confidence. South Africa would do well to follow suit.

4.2 The issue of treaty shopping

Article 12(1) of the 1992 OECD Model Convention states that:

royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties.

This paragraph is identical to that used in the 1977 OECD Model. The 1963 Draft Convention made no mention of a resident being the "beneficial owner" of the royalties.

According to the 1977 OECD Commentary on Article 12, paragraph 1 lays down the principle of the exclusive taxation of royalties in the State of the beneficial owner's residence. (The only exception to this principle is made in cases dealt with under Article 12(3), where royalties are effectively connected with a permanent establishment or fixed base in the source state.) This exemption from tax in the State of source is not available where an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, and the "beneficial" owner is not a resident of the other Contracting State.

The problem that this paragraph seeks to avoid is that of the use or "borrowing" of income tax treaties by persons beyond the natural sphere of treaty beneficiaries. If the country of source negotiates a treaty whereby it exempts royalties from any withholding tax, the benefits of the treaty could be available to residents of other countries (which are not a party to the agreement) by the act of

(1995) 5 Revenue L J

incorporating a company in the country of a treaty partner - known as a "conduit company". This device is known as "treaty shopping".

Provisions to counteract treaty shopping gained a great deal of momentum in the US in the 1980s, mainly as a reaction to the tax shelter structures that were built around the exemption for royalties in certain DTAs, especially that between the US and the Netherlands Antilles. A favourite vehicle for the distribution of motion pictures in the US was a Netherlands Antilles corporation that either owned the picture or licensed it from its producer.⁴⁶ The proliferation of schemes such as these led to the ultimate repeal of the DTA with the Netherlands Antilles in 1987, and to the incorporation of strict anti-treaty shopping measures in US treaties.

In 1981, the US included a "limitation on benefits" article in its Treasury Department's Model Income Tax Treaty. The provisions of this article vary according to the US relationship with the treaty partner concerned, but generally they focus on three factors:

(1) the extent to which the treaty country corporation is owned by third-country residents; (2) the extent to which deductible payments to third-country persons reduce the taxable income of the treaty country company (so-called "base erosion"); and (3) the purpose for which the treaty country corporation was established and the nature of its activities.⁴⁷

Unless the treaty country corporation has more than 75% share ownership by residents and does not make substantial deductible payments to third country residents, it will not be entitled to claim treaty benefits. The restrictions thus focus on "conduit companies" which receive treaty benefited income and then make deductible payments which are not subject to treaty country withholding tax:

these tests, expressed in percentage terms, in effect function as "safe harbors". If the corporation does not meet these mechanical tests, it will still be entitled to treaty benefits if under a more general "purpose" test it can establish that obtaining treaty benefits was not one of the principal purposes of establishing and conducting operations through the treaty country corporation.⁴⁸

⁴⁶ Isenbergh, above n 17 at 410-411.

⁴⁷ McDaniel PR and Ault HJ, *Introduction To United States International Taxation* (3rd revised ed 1989) 178.

⁴⁸ Ibid.

The aim of these tests is to prevent a manipulation of the US royalty provisions by residents of states that are not treaty partners.

It has been argued that the inclusion of "limitation on benefits" rules in US DTAs is a demonstration of its changing attitudes to source-based taxation. As the US has been evolving from a technology and capital exporting country to being a capital and technology importing country, so it has simultaneously been moving towards a position where it seeks to ensure that where withholding taxes on royalties fall due to be paid, they are actually collected. There is a realisation that it cannot afford to lose the tax revenue generated by royalties.

Although there are benefits to incorporating anti-treaty shopping measures into royalty provisions, as far as South Africa is concerned:

the use of the South African treaties by residents of third countries does not seem to pose a problem for "inbound" investments (investments into South Africa). It has not reached such proportions as to create concern among the South African Revenue authorities. The South African courts have also not yet been asked to decide on issues in which sham transactions or transactions without any business purpose involving benefits available under a treaty have been questioned. And specific statements of practice on treaty shopping have not been issued by the South African Revenue authorities.⁴⁹

South Africa would benefit by bringing its treaty provisions into line with Article 12(1) of the 1992 OECD Draft by incorporating references to beneficial ownership, thereby preventing mere intermediaries from benefiting under the DTA royalty provisions. While it is apparent that this is not an issue which is of concern to the South African revenue authorities (it was not mentioned in the Interim Report), one cannot ignore the possibility that this may become a problem in the future. At the moment, none of the South African treaties contain anti-treaty shopping measures in their royalty provisions. The introduction of a limitation on benefits article into South African treaties would, however, probably not serve any purpose unless the tax administration, which as mentioned earlier is "dangerously stretched", could actually give effect to the terms of the article. Another obstacle worth considering is that "it hardly matters how many treaties have restraints on treaty shopping if there is only one treaty with a

⁴⁹ Passos A, *Tax Treaty Law* (1986) 267.

(1995) 5 Revenue L J

potential tax haven country that does not.”⁵⁰ The royalty provisions of each operating DTA would thus have to be examined and amended.

Australia has also not paid much attention to the problem of treaty shopping,⁵¹ and writers have expressed the concern that: “it must be assumed that astute persons not intended to be benefited are utilising the provisions of the treaties in order to reduce their liability to Australian tax”.⁵² Australia only has a Limitation on Benefits article (Article 16) with the United States. This article eliminates treaty benefits for corporations not more than 75% beneficially owned by individual residents of their country of incorporation. The effect of this article is:

virtually to eliminate treaty shopping. The only avenue under Article 16 for nonresidents of a country to obtain the benefits of its treaty with the US is to establish ties of residence with that country. Only the most mobile and tax-averse would go that far.⁵³

However, before suggesting the implementation of a limitation on benefits article to ensure that royalty provisions are not abused, the comments of US legal writers on the realities of putting such a provision into practice should be noted.

Rosenbloom puts forward the view that:

on the usual US principle that anything worth doing is worth overdoing, recent formulations of these provisions have taken the limitation on benefits article to new heights, or depths, of detail and complication. This strikes me as a dubious development. The limitation on benefits article is inevitably difficult to administer. There has not been a single reported instance in which one of these provisions has been invoked in the 15 years they have been around. The article was never intended to require elaborate interpretation, and it was never intended to occupy substantial time of the competent authorities or the courts. It was intended as a prophylactic device tending to limit treaty benefits in general to preclude a given treaty from operating in favour of the entire world. Such a purpose does not require an Internal Revenue Code in miniature.⁵⁴

⁵⁰ Isenbergh, above n 17 at 474.

⁵¹ Arnold BJ, “Future Directions in International Tax Reform” (1988) *Australian Tax Forum* 462.

⁵² Hamilton and Deutsch, above n 8 at para 648.

⁵³ Isenbergh, above n 17 at 473.

⁵⁴ Rosenbloom, above n 34 at 92.

If the sophisticated Internal Revenue Service of the US is having problems in implementing the provisions of Article 16, there is no doubt that other revenue authorities around the world would similarly battle to give effect to these clauses. The suggestions are that not only should such extremely complex legislation not be introduced, but that existing legislation should be simplified.⁵⁵ Another criticism of limitation on benefits clauses is that, by creating obstacles to tax treaty relief, they are deterring investment from third countries. The UN Ad Hoc Group of Experts has been particularly concerned with the detrimental effect this could have on developing countries, and has gone so far as to suggest that there should be a presumption that bona fide recipients can claim treaty benefits.⁵⁶

The coup de grace on the limitation of benefits provision was administered by the report issued by the American Law Institute (ALI) at its 68th Annual Meeting in May 1991, which not only observed that the United States had “overreacted to the treaty-shopping problem”, but further noted that “those limitation provisions, while perhaps appropriate for tax haven countries, are intrusive to normal international economic relationships”.⁵⁷

This is probably why neither the 1992 OECD Model Tax Convention nor the Common Market Commission have felt the need to introduce limitation on benefits provisions. Comments such as those expressed above should serve as a deterrent to South Africa and Australia introducing similar complex, and ultimately largely unnecessary, legislation in order to protect their flow of royalty income.

⁵⁵ Simplification is, of course, a topic that is on everyone’s lips, readily readable and widely embraced, at least in the abstract. All would likely agree, though in varying degrees, that the Code provisions dealing with US taxation of foreign persons can, and should, be simplified. The US has exercised undeniable leadership, if that is the word, in drafting complex, microregulatory, anti-abuse driven statutory provisions in the international tax area that are second to none (this writer, however, has seen no evidence that any other sovereign has even the slightest interest in following that leadership).
Eustice JS, “Commentary” 9 (Spring 91) *American Journal of Tax Policy* 102.

⁵⁶ Piciotto, above n 9 at 162.

⁵⁷ Streng W, “‘Treaty Shopping’: Tax Treaty ‘Limitation of Benefits’ Issues” 15 (Fall 92) *Houston Journal of International Law* 1 at 25.

(1995) 5 Revenue L J

4.3 The issue of transfer pricing

Article 12(4) of the 1992 OECD Model Treaty deals with the case of a "special relationship" between the parties leading to an "excessive" amount being paid in royalties:

Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

The 1992 Draft of this Article is identical to the 1977 version. The 1977 OECD Commentary gives examples of such a special relationship where: "royalties are paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having a common interest with him."⁵⁸ The concept of a special relationship also covers relationships by blood or marriage, and can refer to any community of interests as distinct from the legal relationship giving rise to the payment of the royalty.⁵⁹

The Commentary also provides that the exact nature of the excess part of the royalty will have to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purpose of applying the provisions of the tax laws of the countries concerned and the provisions of the Convention. If this should prove difficult, countries could introduce additional classifications, as long as they did not alter the "general purport" of the paragraph.⁶⁰

What this paragraph is seeking to avoid is the situation whereby related parties price their transactions not according to "arm's length" or legitimate market considerations, but in order to avoid the incidence of tax. This device is known as "transfer pricing." The pricing of royalties is of particular concern, as new technology is, per se, a difficult item to assess in monetary terms.

⁵⁸ At Part II, para 18.

⁵⁹ At Part II, para 19.

⁶⁰ At Part II, para 20.

The taxation implications of transfer pricing have been extensively scrutinised by revenue authorities worldwide, with the result that: "the most significant change in tax policy in recent years is the increased recognition that the real issues of international taxation do not relate as much to macro-economic criteria or even equity considerations like capital import or export neutrality but issues involving transfer prices between related parties and establishing the correct net income in a taxing jurisdiction".⁶¹

DTAs play an important role in resolving transfer pricing controversies, as domestic tax provisions, "however refined they may be in addressing the fiscal implications of international trade and investment, cannot by themselves decide issues or disputes which require the cooperation of another State."⁶² However,

an unavoidable aspect of tax treaties is that they cannot go into fine detail, either in matters of policy or technical definition. Tax treaties are not taxing statutes and are not interpreted as such. They represent consensus, in some respects contractual, on broad principles. Equally, domestic tax systems are subject to constant change in detail, and the treaty must be broad enough not to go out of date in the medium term. This means that where transfer pricing issues are concerned, tax treaties may assist in a broad sense, but important matters of detail will rely on the domestic law of the contracting States.⁶³

The Australian treaty provisions in respect of transfer pricing are up-to-date with the latest 1992 OECD version of Article 12(4), and there is also advanced domestic legislation dealing with pricing arrangements which shift profits from high to low tax countries.⁶⁴ The scope of these provisions is comprehensive, and they present a powerful weapon against a broad range of transactions that can be identified as breaching the arm's length criteria. The motivation for introducing such complex and sophisticated legislation in Australia, (which, as a developed country, has an inevitably high tax rate), was the prevention of the erosion of the tax base. The introduction of transfer pricing rules is becoming an increasingly important issue to the South African fiscus, as South Africa has a comparatively high tax rate, especially for a developing country seeking to attract investment. At the moment, South Africa has

⁶¹ Ross SG, "US International Tax Policy: Where Are We? Where Should We Be Going?" 43 (1990) *Tax Notes* 338.

⁶² Pagan JC and Scott Wilkie J, *International Transfer Pricing* (1993) 207.

⁶³ *Ibid* at 209.

⁶⁴ Div 13 of Part III of the Income Tax Assessment Act 1936.

(1995) 5 Revenue L J

neither international nor domestic provisions dealing with transfer pricing.

As far as domestic legislation is concerned, s 103(1) of the South African Income Tax Act embodies a general anti-tax avoidance provision. The tax authorities can tax an amount, ignoring any scheme entered into, if they can demonstrate that a transaction, operation or scheme has had the effect of avoiding or postponing the liability for tax. The primary criteria are that, considering the circumstances, the transaction was entered into in an abnormal manner or that it created rights or obligations which would not normally be created between persons dealing at "arm's length". The transaction must also have been entered into solely or mainly for the purpose of avoiding or postponing tax.

It has been argued that the application of s 103 will imply that the South African courts will be able to read an "anti-abuse" clause into a DTA. However:

such a wide interpretation is neither permitted in terms of the international rules of interpretation, nor by South African rules of interpretation. Its application will thus contravene the customary international law rule that a contracting State may not apply its national law rules to justify its failure to perform its treaty obligations.⁶⁵

The Interim Report likewise concedes that s 103 is ineffective as an instrument against transfer pricing.⁶⁶ It also expresses a concern that both local and foreign international traders will seek to transfer profits from the high South African tax jurisdiction to lower jurisdictions.⁶⁷ This is a very real concern, as the ability to siphon out profits relating to royalties could potentially undo all the benefits to South Africa of the inward flow of technology from a revenue point of view.

The incorporation of the provisions of Article 12(4) of the 1992 OECD Model Convention into South African DTAs would be a step in the right direction towards the guarding against international transfer pricing. However, as noted above, domestic legislation would have to provide important matters of detail. In this regard the Interim Report recommends that anti-transfer pricing legislation be introduced, but that reliance be placed on "arm's

⁶⁵ Eskinazi, above n 29 at 130.

⁶⁶ Interim Report, above n 4 at para 14.6.23.

⁶⁷ Ibid at para 14.6.22.

length" concepts to dictate acceptable pricing practices, as is the case with the United Kingdom and other countries which rely strongly on OECD guidelines.⁶⁸ One of the reasons given for this approach is that a rigid codified system would lie outside the administrative capacity and experience of the South African revenue authorities at this time. It was asserted that to pass laws which could not be enforced effectively would be to weaken the very core of the legal system.⁶⁹ Caution was also expressed regarding the grafting of foreign solutions onto local situations.⁷⁰

This is an understandable viewpoint, as one must generally beware of simply transposing the current sophisticated treaty provisions of a developed country onto the treaty system of a developing country. Comparative lawyers are aware that, "importing bleeding chunks of alien doctrine could prove extremely dangerous".⁷¹ Moreover:

any tax provision must be seen in the context of a country's tax system as a whole, its legal system and even its culture. A solution that is satisfactory for one country may be quite inappropriate for another.⁷²

The final conclusion reached by the Interim Report was that basic provisions for anti-transfer pricing measures be brought into the Income Tax Act without delay, but that such measures be used to control extreme cases rather than to strangle international investment with excessive aggression.⁷³

Although the "arm's length" concept is not without flaws, it is a far more suitable method of determining an acceptable price for a developing country than the formula apportionment calculation applied in the United States, which entails a set of formal, detailed and binding rules. The arm's length method also has the advantage of being a fundamental feature of the OECD Model Convention, with the corollary of international familiarity and acceptance. (The arm's length principle was in fact incorporated into the original regulations governing Section 482 of the US Internal Revenue Code, although the latest draft regulations appear to depart from this principle.)

⁶⁸ Ibid at para 14.6.25.

⁶⁹ Ibid at para 14.6.26.

⁷⁰ Ibid at para 14.6.29.

⁷¹ Arnold, above n 51 at 453.

⁷² Ibid.

⁷³ Interim Report, above n 4 at para 14.6.33.

(1995) 5 Revenue L J

There is also a need for developing countries, such as South Africa, to balance their zeal to prevent tax avoidance through the abuse of royalty provisions with their perhaps greater need to encourage foreign investment, trade and technology flows and thus extend their share of world markets. It cannot be overemphasised that "care needs to be exercised so as not to push legitimate protection against abuse to a level which would discourage foreign investment and trade".⁷⁴

5 Conclusion

As developing countries such as South Africa begin to become part of a more integrated world economy, so they are faced with the growing need to reform and upgrade their international tax policies, and in particular their double taxation treaties. The implementation of efficient international tax laws dealing with the flow of technology is especially important, as developing economies are reliant on the importation of foreign technology in order to compete in the global marketplace. At the same time, there is a need to counteract the potential for the shifting of profits out of South Africa through the manipulation of the existing relatively unsophisticated laws, and the taking advantage of the lack of anti-abuse legislation. It was likewise the prevention of such abuse which motivated the impressive anti-avoidance legislation evident in Australia's domestic and international legislation, although it must be borne in mind that the Australian fiscus had the advantage of an advanced and up-to-date revenue system with the administrative power to implement such rules.

As far as South Africa is concerned, the appointment of a Commission of Inquiry into certain aspects of the South African tax structure in June 1994 is an indication of an awareness of the need to upgrade its tax system in order to meet the demands of the 21st century.

The royalty provisions of South Africa's double taxation treaties are, as they stand, out-of-date and simply not designed to handle the complexities of technology transfer transactions in the 1990s. Some treaties do not even contain an article dealing with royalties.⁷⁵ Considering the critical importance of access to current

⁷⁴ Ibid at para 14.6.26.

⁷⁵ The treaties which South Africa entered into with Gambia, Nicaragua, Mauritius, Seychelles and Sierra Leone in 1946, and with Kenya,

technology to South Africa as a developing country, it cannot afford to have inappropriate international legislation acting as a disincentive to technology transfers, because of the uncertainty as to how such transactions will be dealt with by the South African revenue authorities. This was a particular concern voiced in the Interim Report, as potential investors and foreign business concerns had expressed a desire for reasonable certainty as to the likely tax treatment of a given set of facts.⁷⁶

While there is a need to update the royalty provisions of South Africa's DTAs, the desire to introduce complex legislation necessitating a highly sophisticated system of administration, such as in place in the US and Australia, should be curbed. There is a global move towards simplifying statutes, which was reflected in the opening paragraph of the 1984 US Treasury Report to the President: "The present US Tax System desperately needs simplification and reform. It is too complicated..."⁷⁷ Such thoughts have been echoed in the Netherlands, Belgium, the United Kingdom and Australia.⁷⁸ It is important to structure legislation dealing with international intellectual property transfers carefully and, in the case of a developing country, to introduce simple and straightforward provisions that will ensure more consistent tax treatment of royalties.

There is a need for a revision of the royalty provisions. It is desirable to introduce legislation that is up-to-date, clear, brief and easy to administer, yet effectively preventing tax avoidance. Accordingly, South Africa should adopt a set of rules that have already gained international acceptance, namely the 1992 OECD draft provisions on royalties. Ideally, these provisions should be incorporated into its existing treaties, as well as into its future treaties. While there are always logistical problems involved in the renegotiation of treaties, South Africa's current position as a country on the threshold of a new era of international acceptance is one uniquely suited to such a restructuring of agreements. In the final analysis,

technology is...the transfer of knowledge. Every step should be taken to facilitate this process.⁷⁹

Tanganyika, Uganda and Zanzibar in 1960 do not contain articles dealing with royalties.

⁷⁶ Interim Report, above n 4 at para 14.7.1.

⁷⁷ Williams, above n 1 at para 165.

⁷⁸ Ibid.

⁷⁹ Brown CA, *Tax Aspects Of The Transfer Of Technology: The Asia-Pacific Rim* (1990) 444.