



Legal Counsel

Income Tax

**Guide on the
Taxation of Franchisors and Franchisees**



South African Revenue Service

Guide on the Taxation of Franchisors and Franchisees

Preface

This guide considers the income tax implications of income received and expenditure incurred by franchisors and franchisees.

It is not an “official publication” as defined in section 1 of the Tax Administration Act 28 of 2011 and accordingly does not create a practice generally prevailing under section 5 of that Act. It is also not a binding general ruling under section 89 of Chapter 7 of the Tax Administration Act. Should an advance tax ruling be required, visit the SARS website for details of the application procedure.

This guide is based on the legislation as at date of issue.

All guides, interpretation notes, forms, returns and tables referred to are available on the SARS website at **www.sars.gov.za**.

For more information you may –

- visit the SARS website at **www.sars.gov.za**;
- visit your nearest SARS branch;
- contact your own tax advisor or tax practitioner; or
- contact the SARS National Call Centre –
 - if calling locally, on 0800 00 7277; or
 - if calling from abroad, on +27 11 602 2093 (only between 8am and 4pm South African time).

Comments on this guide may be sent to **policycomments@sars.gov.za**.

Prepared by

Legal Counsel
SOUTH AFRICAN REVENUE SERVICE

Date of issue : 21 July 2016

CONTENTS

Preface	i
Glossary	1
1. Introduction	1
2. The franchise arrangement	1
3. Taxation of franchisors and franchisees	2
3.1 Creation, acquisition, or use of intellectual property	3
3.1.1 Tax implications for franchisors: Creation or acquisition of intellectual property	3
3.1.2 Tax implications for franchisees: Licence fee	5
3.2 Initial fees	8
3.2.1 Tax implications for franchisors	9
3.2.2 Tax implications for franchisees.....	10
3.3 Royalty payments	12
3.3.1 Tax implications for franchisors	12
3.3.2 Tax implications for franchisees.....	13
3.4 Example – Taxation and/or deductibility of initial fees, licence fees and royalty payments..	15
3.5 Royalties paid on “tainted intellectual property”	16
3.6 Withholding tax on royalties.....	19
3.7 Early cancellation of a franchise agreement	20
3.7.1 Compensation paid by a franchisor for early termination of a franchise agreement	20
3.7.2 Compensation paid by a franchisee for early termination of a franchise agreement	22
3.8 Penalties for breach of contract.....	23
3.9 Renewal fees.....	23
3.10 Advertisement fees.....	23
3.10.1 Tax implications for franchisors	23
3.10.2 Tax implications for franchisees.....	24
3.11 On-going training fees	24
3.11.1 Tax implications for franchisors	24
3.11.2 Tax implications for franchisees.....	24
3.12 Capital gains tax.....	24
3.13 Restraint of trade payments	26
4. Conclusion	27

Glossary

In this guide unless the context indicates otherwise –

- “**CGT**” means capital gains tax, being the portion of normal tax attributable to the inclusion in taxable income of a taxable capital gain;
- “**Copyright Act**” means the Copyright Act 98 of 1978;
- “**Designs Act**” means the Designs Act 195 of 1993;
- “**Income Tax Act**” means the Income Tax Act 58 of 1962;
- “**Patents Act**” means the Patents Act 57 of 1978;
- “**section**” means a section of the Income Tax Act;
- “**Schedule**” means a Schedule to the Income Tax Act;
- “**South Africa**” and “**Republic**” are used interchangeably;
- “**taxpayer**” and “**person**” are used interchangeably;
- “**Trade Marks Act**” means the Trade Marks Act 194 of 1993;
- any other word or expression bears the meaning ascribed to it in the Income Tax Act.

1. Introduction

The growing franchise industry in South Africa is a major contributor to the South African economy. The rapid rate at which new franchises are entering the market has given rise to a need for clarity concerning the tax implications that arise in relation to franchise arrangements. More particularly, there is a need to examine the tax treatment of income received and expenditure incurred by both franchisors and franchisees. This guide focuses mainly on transactions between franchisors and franchisees that are resident in South Africa. The aim of this guide is to assist in clarifying uncertainties that may arise on the application of the tax laws to a franchise arrangement.

2. The franchise arrangement

In order to facilitate a better understanding of the franchising industry, some of the most commonly used terms relating to franchises, as defined by the International Franchising Association,¹ are listed below:

- **Business format franchise:** This type of franchise includes not only a product, service and trademark, but also the complete method to conduct the business itself, such as the marketing plan and operations manuals.
- **Franchise:** A licence that describes the relationship between the franchisor and franchisee, including the use of trade marks, fees, support and control.
- **Franchising:** A method of business expansion characterised by a trade mark licence, payment of fees and significant assistance and/or control.
- **Franchisor:** The person or company that grants the franchisee the right to do business under its trade mark or trade name.

¹ www.franchise.org/what-are-common-franchise-terms [Accessed 11 July 2016].

- **Franchisee:** The person or company that acquires the right from the franchisor to do business under the franchisor's trade mark or trade name.
- **Franchise agreement:** The legal, written document that governs the relationship between the franchisor and franchisee.
- **Product distribution franchisee:** A franchise in which the franchisee simply sells the franchisor's products without using the franchisor's method of conducting business.
- **Royalty:** The regular payment made by the franchisee to the franchisor, usually based on a percentage of the franchisee's gross sales.
- **Trademark:** The marks, brand name and logo that identify a franchisor which is licensed to the franchisee.

A franchise arrangement will usually enable a franchisee to operate a business under specific licensing conditions. As noted above, a business format franchise arrangement provides the franchisee with a strong brand (intellectual property) and "the complete method to conduct the business itself, such as the marketing plan and operations manuals" (business processes). By contrast, a product distribution franchise arrangement does not involve the franchisor providing the franchisee with its method of conducting business (business processes). While this guide is focused on the business format franchise arrangement (hereinafter merely referred to as a "franchise"), many of the concepts and commentary is of application to a product distribution franchise arrangement.

The franchisor that establishes or develops a concept normally uses franchisees to duplicate and distribute the concept on a large scale. The success of a franchise chain lies in the effective implementation of basic, but clearly defined, business principles that have been established by the franchisor.²

3. Taxation of franchisors and franchisees

The income of franchisors and franchisees consists of a wide range of payments and receipts which are stipulated in the franchise agreement. Franchisors, for instance, receive payments such as initial fees, renewal fees and royalties from the franchisee. In exchange, the franchisor has to provide the necessary intellectual property and business processes to enable the franchisee to operate the franchise.

The franchisee on the other hand incurs initial expenditure in setting up the franchise outlet, as well as expenditure relating to the day-to-day running of the franchise which can either be in the form of once-off or recurring payments.

Different tax consequences may attach to amounts received by a franchisor and a franchisee. A receipt of an amount by a franchisee or franchisor may constitute "gross income" as defined in section 1(1). "Gross income", in the case of a resident, is –

- the total amount received or accrued during the year of assessment, regardless of the country of source,
- but excluding receipts and accruals of a capital nature.

² www.fasa.co.za [Accessed 11 July 2016].

All amounts that the resident franchisor or franchisee receives will thus fall into gross income, with the exception of those of a capital nature.

For a non-resident, “gross income” is the total amount received or accrued from a source within South Africa, but excluding receipts and accruals of a capital nature.

As regards expenses or losses to be deducted from a franchisor’s or franchisee’s “income” (gross income after deducting any amounts exempt from tax), the requirements set out in section 11(a) read with section 23(g) (the general deduction formula) must be complied with, that is, the expense or loss must –

- be actually incurred;
- during the year of assessment;
- in the production of the franchisee’s or franchisor’s income; and
- not be of a capital nature.

Further, the expenditure must be laid out or expended for the purposes of trade.

In the event that a person has actually incurred expenditure (excluding expenditure incurred to acquire trading stock) during a year of assessment for which a deduction is allowable under sections 11(a), 11(c), 11(d), 11(w) or 11A, a deduction may be limited under section 23H if it relates to –

- goods or services that will not be supplied or rendered to the person in its entirety during the year of assessment in which the expenditure was incurred, or
- any other benefit for a period that extends beyond the end of that year of assessment.

This section essentially provides for the deferment of deductions of the pre-paid expenditure, which is then spread over the number of years of assessment during which the goods are supplied, the services rendered or the benefits enjoyed.

Commentary that explains the tax treatment of certain specific types of income and expenses relevant to franchisors and franchisees is provided below.

3.1 Creation, acquisition, or use of intellectual property

Franchisors will usually register their distinctive intellectual property, such as trademarks, patents and designs (which are normally developed by them), before the commencement of their franchise business. Registration is important in order to protect their interests in the intellectual property and to prevent the occurrence of any form of infringement or unlawful competition, such as passing-off by competitors.

A franchisee must also obtain a right to use the franchisor’s intellectual property and business processes in order to legally trade.

3.1.1 Tax implications for franchisors: Creation or acquisition of intellectual property

In order to determine whether the cost incurred by a franchisor in developing or acquiring intellectual property would qualify as a deductible expense, the nature of the expenditure as well as the purpose of the expenditure must be evaluated. It is necessary to differentiate between expenses incurred to create an income-producing structure and those incurred to operate the income-producing structure.

In *CIR v George Forest Timber Company Ltd*, Innes CJ held as follows:³

“Money spent in creating or acquiring an income-producing concern must be capital expenditure. It was invested to yield future profit and while the outlay did not recur, the income did. *There was a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one was capital expenditure, the other was not.*”

(Emphasis added)

The costs incurred by a franchisor in –

- obtaining a patent;
- devising or developing an invention;⁴
- creating or producing a design, copyright or any property of a similar nature;
- the registration of a trademark, trade name or design;
- the restoration or extension of any patent;
- the extension of the registration period for a design; and
- the renewal of the registration of a trade mark or trade name,

would in most instances be capital in nature since it is regarded as money spent in creating or acquiring an income-producing asset.

Subject to certain requirements, the expenses referred to above could, however, be deductible in the following circumstances –

- Section 11(gB) provides for the deduction of expenditure actually incurred in obtaining the granting or restoration or the extension of the term of any patent, the registration or extension of registration of any design, or the registration or renewal of registration of a trade mark if the patent, design or trade mark is used by the taxpayer in the production of the taxpayer’s income.
- Section 11(gC) provides for an allowance of 5% a year of the expenditure actually incurred during years of assessment commencing on or after 1 January 2004⁵ to acquire (otherwise than by developing or creating) any –
 - invention or patent as defined in the Patents Act;
 - design as defined in the Designs Act;
 - copyright as defined in the Copyright Act; or
 - property of a similar nature.

Additionally, a franchisor whose trade relates to gambling, telecommunications or the exploration, production or distribution of petroleum and who is required to first obtain a licence from the national, provincial or local government may claim a deduction for the licence fees under section 11(gD). The deduction under section 11(gD) must not exceed, for

³ 1924 AD 516, 1 SATC 20 at 26. This approach has subsequently been reaffirmed on numerous occasions by our courts.

⁴ See Interpretation Note 50 dated 28 August 2009 “Deduction for Scientific or Technological Research and Development” for more information on inventions in relation to section 11D.

⁵ Certain expenditure incurred prior to 1 January 2014 in relation to inventions, patents, designs, trade marks or copyright may have been deductible under section 11(gA).

any one year, such portion of the licence fee as is equal to the amount of the expenditure divided by the number of years for which the taxpayer has the right to the licence after the date on which the fee is incurred, or 30 years, whichever is the lesser.

3.1.2 Tax implications for franchisees: Licence fee

The lump sum amount expended by a franchisee in obtaining a licence for the right of use of the franchisor's intellectual property and business processes can be made as a separate payment or could be included as a portion of the initial fee (see 3.2). This upfront licence fee is generally paid in addition to the royalty payments that a franchisee is required to make to a franchisor for the continued use of the relevant intellectual property and business processes granted by the franchisor under the licence agreement (see 3.3).

In ITC 1726,⁶ it was held that a licence granted by the State to enable the taxpayer to operate a non-exclusive cellular service for a renewable period of 15 years was of such an enduring nature that the licence fee was of a capital nature and therefore not deductible. The learned judge noted further that "it would appear that the payment (of the licence fee) is more closely connected with the [taxpayer's] income-earning structure rather than [its] income-earning operations",⁷ and for that reason could also be regarded as being of a capital nature. As regards the annual licence fee payable by the taxpayer, the court found that the recurrent expenditure was paid to maintain the advantage of having the licence and was accordingly of a revenue nature and deductible under the general deduction formula.

Mention must also be made of the decision in *C: SARS v I-Net Bridge (Pty) Ltd.*⁸ In this case, the taxpayer had made an advance payment of 5 years of annual licence fees. The up-front lump sum payment was made to a UK company for the licence to use the "Bridge System", "Bridge Source Code" And "Bridge Data Feed". The System and Code were necessary to enable the data to be supplied by the UK company to I-Net Bridge to be converted into a readable and usable format. This Data was in turn disposed of to its customers by I-Net Bridge. It was argued by the taxpayer that the advance payment of the annual licence fees was paid for trading stock that was subsequently disposed of to its customers. SARS in turn argued that that on a proper reading of the agreement the advance payment of the annual licence fees was not paid for the Bridge Data Feed (the trading stock referred to by the taxpayer), but only the Bridge System and Bridge Code. Victor J rejected the argument by SARS, noting that the Bridge System, Bridge Source Code and the Bridge Data Feed were all interrelated and without any one component there would not be any readable data (trading stock).

The learned judge held that:

"In my view the true legal nature of the transactions show that *the expenditure is for the acquisition of data being the 'trading stock'* and the money outlaid for the acquisition of the integrated system was its floating capital used wholly for the purposes of trade. The expenditure *is not of an enduring asset, nor a once and for all payment.* (Payment 5 years in advance does not change its character as an annual fee). A valid commercial reason was given for fixing the price upfront over a 5 year period, namely, the depreciating rand currency at the time. The expenditure did not alter the nature of the business; *it made the trading stock more attractive*".⁹

(Emphasis added)

⁶ (2000) 64 SATC 236 (G) at 240.

⁷ At 241.

⁸ 73 SATC 141.

⁹ At page 147.

As will be apparent, the facts of the *I-Net Bridge* case were unique and the fact that the licence fees were payable annually, albeit paid in advance, clearly carried considerable weight. The decision of the court is certainly not authority for the view that an advance payment by a franchisee to a franchisor of annual licence fees made to secure the use of the franchisor's intellectual property and business processes will in all cases be of a revenue nature.

Rather, the view is held that an lump sum upfront licence fee paid by a franchisee to a franchisor for the grant of the right of use of the franchisor's intellectual property and business processes is akin to the licence fee paid by the taxpayer in *ITC 1726* in that the rights acquired under the licence agreement are necessary to enable the franchisee to establish its income-earning structure and, depending on the duration of the licence arrangement, is also of an enduring nature. Stated differently, the lump sum upfront licence fee will not have been routinely incurred in operating the franchisee's business, but has rather been incurred in acquiring the right to use the franchisor's intellectual property and business processes. The lump sum upfront licence fee is accordingly of a capital nature and not deductible under the general deduction formula. In the event that this payment is made in instalments, it will also be non-deductible. In *ITC 353*¹⁰ the question considered was whether a payment of annual instalments for a licence to work a patent was to be treated on revenue account or whether it was a payment relating to capital assets. It was held that a recurring capital payment is still a capital payment irrespective of the fact that it is paid in instalments.

While, as noted above, provision is now made under section 11(gD) for the deduction of the cost incurred by a taxpayer that –

- provides *telecommunication services*;
- is involved in the *exploration, production or distribution of petroleum products*; or
- provides facilities for *gambling*,

in *acquiring* a licence from a *national, provincial or local government*, the upfront licence fee paid by a franchisee to a franchisor will clearly not qualify for deduction under that section. However, should a franchisee incur expenditure in acquiring a licence from a national, provincial or local government, the expenditure may be deducted over the period that the franchisee has a right to the licence, or 30 years, whichever is the lesser.

If an upfront licence fee is paid by a franchisee to a franchisor for the grant of the right of use of any patent, trademark, copyright or other similar property, or the imparting of any knowledge in relation to the use of the intellectual property, an allowance for the upfront licence fee may be claimed by the franchisee under section 11(f)(iii) or (iv) respectively if the requirements are met.

An allowance is available under section 11(f)(iii) or (iv) if the licence fee constitutes “a *premium or consideration in the nature of a premium* paid by (the franchisee) for –

- (iii) the right of use of any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or of 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; or

¹⁰ (1936) 9 SATC 82(U).

- (iv) 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”.

(Emphasis added)

The allowance is calculated as a portion of the amount of the premium or like consideration divided by the number of years (limited to 25 years) for which the franchisee is entitled to use the intellectual property.¹¹

A “premium or consideration in the nature of a premium” has been interpreted by our courts in the context of leasehold improvements to be “consideration passing from a lessee to a lessor, whether in cash or otherwise, *distinct from and in addition to, or in lieu of, rent*”.¹² (Emphasis added)

A lump sum upfront licence fee paid by a franchisee to a franchisor for the grant of the right of use of the intellectual property referred to in section 11(f)(iii) or for imparting knowledge in relation to the use of such intellectual property, would constitute a “premium or consideration in the nature of a premium” if it can be said that such licence fee is paid in addition to, or in lieu of, any recurrent consideration (for example, an annual licence fee) payable by the franchisee to the franchisor for the continued use of the intellectual property specified in section 11(f)(iii) or knowledge in relation to such intellectual property.

While a lump sum upfront licence fee paid by a franchisee to a franchisor is considered to be capital in nature, it is accepted there may be exceptional circumstances in which the relevant licence fee could be of a revenue nature. The ultimate determination will depend on the specific facts relating to the licensing arrangement, including the purpose for which the licence was acquired by the franchisee. However, in the event that the licence fee is of a capital nature but constitutes a “premium or consideration in the nature of a premium” as contemplated in section 11(f), and the licence fee clearly relates to the right of use of the intellectual property specified in section 11(f)(iii) or any other property which is of a similar nature, or the imparting of knowledge connected with such intellectual property, the franchisee will be permitted to claim an allowance under section 11(f)(iii) or (iv), whichever may be of application.

Section 11(f)(iii) includes the words “any other property which is of a similar nature”. This phrase was also contained in the repealed section 11(gA) and its meaning was considered in *C: SARS v SA Silicone Products (Pty) Ltd*.¹³ In this case, the court had to decide whether a licence to use a trademark constituted property similar in nature to a trademark.

Heher JA stated the following as regards the expression “any other property which is of a similar nature”:¹⁴

“The expression, properly interpreted, requires, in my view, that any property which is similar in nature shall possess fundamental characteristics common to those possessed by the specifically identified properties; minor or superficial similarities will not of themselves suffice...The common natures of the identified properties,...embrace their intellectual origins, i.e. their derivation from a creative mind, their potential for commercial exploitation, the fact that the law regards such exploitation as creating a justifiable monopoly which is available only to

¹¹ Paragraph (aa) of the proviso to section 11(f).

¹² *CIR v Butcher Bros (Pty) Ltd, 1945 AD 301, 13 SATC 21 at 33.*

¹³ 2004, 66 SATC 131.

¹⁴ At 139.

the creator of the property or persons to whom the creator transfers his rights according to law and that the law accords the rights and protection of ownership to such property.”

In the context of section 11(f)(iii), the onus rests on the taxpayer to show how the use of, for example, a manual is of a “similar nature” to the specified intellectual property and that a deduction under this section should be allowed.¹⁵

3.2 Initial fees

An initial fee (also referred to as an up-front fee) is usually paid by a franchisee to a franchisor to enable the franchisee to use the franchisor’s intellectual property as well as its business methods and operating systems (business processes). This fee is generally paid before commencement of trade by the franchisee.

As noted by the International Franchise Association (IFA), under the usual franchise arrangement the “franchisor provides to the franchisee not just its trade name, products and services, *but an entire system for operating the business...site selection and development support, operating manuals, training, brand standards, quality control, a marketing strategy and business advisory support...*”¹⁶ (emphasis added). It will be apparent that an initial fee paid by a franchisee generally does not only relate to the grant by the franchisor to the franchisee of the right of use of its intellectual property, but also to other items, such as for example –

- sales and production forecasting;
- initial training of staff and management;
- forecasting of staff requirements;
- territory analysis;
- site identification;
- operating procedures and standards;
- branding utilisation; and
- supply chain management.

No uniform initial fee rate applies; instead it varies between the different types of franchises, and in some instances between franchises of the same type. Furthermore, some franchise agreements do not require an initial fee to be paid. Instead, a higher annual or monthly fee is paid by the franchisee to secure the rights to operate the franchise (see **3.2.2**).

¹⁵ Section 102(1)(b) of the Tax Administration Act 28 of 2011.

¹⁶ www.franchise.org/what-is-a-franchise [Accessed 11 July 2016].

3.2.1 Tax implications for franchisors

An initial fee received by a franchisor will generally constitute “gross income”¹⁷ for the franchisor.

The initial fee paid by a franchisee to the franchisor is usually in the form of an up-front lump sum payment. As noted above, the initial fee is paid by the franchisee for the acquisition of the right to use the franchisor’s intellectual property and business processes (including the operational standards and procedures), as well as the right to trade in an exclusive use area.¹⁸ The initial fee is thus regarded as the product or fruit derived by a franchisor from putting its capital assets to productive use¹⁹ and is therefore not regarded as a receipt of a capital nature. An initial fee received by a franchisor will thus form part of the gross income of the franchisor.

In ITC 1738²⁰ the taxability of an initial fee received by a franchisor was determined by assessing whether the receipt was a gain made by an operation of business in carrying out a scheme of profit-making. An initial fee had been paid to the franchisor for the use of the franchisor’s “identifications” (trademark, designs, advertising matter, signage, and the like) and “know-how” (technical information relating to planning, setting-up and operating the franchisor’s know-how). It was held that the franchisor’s intellectual property and business processes, that continued to be owned by it, had been productively used by the franchisor to earn income from the granting of the right of their use. The initial fee was therefore held to constitute gross income.

As the court in ITC 1738²¹ had concluded that the initial franchise fee constituted gross income, it was held that it was unnecessary to decide if the initial franchise fee fell within the ambit of paragraphs (g) or (gA) of the definition of “gross income”. Paragraph (g) brings within the ambit of gross income any premium or consideration in the nature of a premium for, amongst other things, the *use of any patent, design, trade mark or copyright, or for the use of any model, pattern, plan, formula or process or any other property of a similar nature.*

As noted above, it is settled law that the meaning of “premium or consideration in the nature of a premium” means an amount paid *in addition to, or in lieu of,* any recurrent expenditure paid for the use of the assets referred to in the provision.²² Paragraph (gA), in turn, provides that any amount received or accrued by a taxpayer as consideration (that is, the consideration need not be in the nature of a premium) for imparting, or undertaking to impart, any technical, industrial or commercial knowledge or information, or any assistance in respect of such knowledge or information, constitutes gross income.

¹⁷ Section 1(1).

¹⁸ An exclusive-use area is a part of the common property that is allocated for the exclusive use of the holder. This area is not owned by any one person or persons. Although these persons have exclusive use of an area and enjoy rights that are similar to ownership rights for the area, they are not legally the owners of it.

¹⁹ ITC 1738 (2000) 65 SATC 37 (C) at 42.

²⁰ (2000) 65 SATC 37 (C).

²¹ (2000) 65 SATC 37 (C).

²² In *CIR v Butcher Bros (Pty) Ltd*, 1945 AD 301, 13 SATC 21 it was held that a “premium” in the context of the rental of immovable property means consideration in the nature of rent passing from a lessee to a lessor over and above, or *in lieu of,* rental payments. It is considered that the same meaning attaches to “premium” in the context of intellectual property, namely, that a “premium” or like consideration is an amount paid by the licensee (franchisee) to the licensor (franchisor) over and above or *in lieu of* the periodic royalty payments for the use of the intellectual property.

An up-front payment of a lump sum initial fee by a franchisee to secure the right of use of the franchisor's intellectual property and business processes would, even if it did not constitute gross income under the general inclusion,²³ constitute gross income under either paragraph (g) or (gA) of the definition of "gross income".

The costs incurred by a franchisor in drawing up the franchise agreement are part of the costs of operating the franchisor's income-earning structure (intellectual property, business processes, and the like), of a revenue nature and thus deductible under the general deduction formula.

3.2.2 Tax implications for franchisees

The upfront payment by the franchisee of the lump sum initial fee grants the franchisee access to the franchisor's pre-existing business processes, intellectual property, exclusive use area and all other support services required to set up and run the franchise operation. In other words, the bundle of rights that is acquired by the franchisee in consequence of the payment of the lump sum initial fee relates not only to the acquisition of the right of use of the franchisor's intellectual property and business processes, but also a myriad of other goods and services necessary for the launch and continuing operation of the franchise (see **3.2**).

The franchisee's aim in entering into a franchise agreement with a franchisor and expending a lump sum in the form of a composite initial fee is therefore to establish an income-producing concern or structure. This fee is consequently of a capital nature and not deductible under the general deduction formula. If the "test" formulated in the *CIR v George Forest Timber* case (see **3.1**) is applied, it may be argued that the initial fee is incurred in creating an income-earning concern (capital) and not spent in working it (revenue).

As with the upfront licence fee discussed in **3.1.2**, a lump sum upfront initial fee or portion thereof may be deductible under section 11(f) provided the requirements of that section are met. However, section 11(f)(iii) and (iv) would only have application in relation to an initial fee if, in the first instance, it can be said that the initial fee constitutes a "premium or consideration in the nature of a premium," that is, the initial fee is paid *in addition to, or in lieu of*, a recurrent payment (e.g. a royalty) paid for the use of the intellectual property specified in section 11(f)(iii), or for the imparting of knowledge connected with the intellectual property [section 11(f)(iv)].

Secondly, the initial fee would need to be paid specifically for the grant of the right of use of the intellectual property or knowledge specified in section 11)(f)(iii) or (iv) respectively.

²³ As held by the court in ITC 1738 (2000) 65 SATC 37 (C).

A composite initial fee that relates to various goods and services to be supplied by the franchisor under the franchise agreement that are not the intellectual property, or knowledge related to the use of the intellectual property, contemplated in section 11(f)(iii) and (iv) respectively (see **3.1.2**), will therefore not qualify for the allowance under section 11(f)(iii) or (iv). However, to the extent that an identifiable component or components of the initial fee relate to the intellectual property or knowledge specified in section 11(f) that may qualify for a deduction under section 11(f), an apportionment will have to be made and the taxpayer will have to substantiate that section 11(f) applies to the identifiable qualifying component or components of the initial fee.²⁴

Thus, even if it can be said that an initial fee constitutes a “premium or consideration in the nature of a premium” in that it can be demonstrated that it is paid in addition to, or in lieu of, a recurrent royalty payment (see **3.3**), the initial fee must still relate solely to the use of the intellectual property specified in section 11(f)(iii), or for imparting knowledge connected with the intellectual property as contemplated in section 11(f)(iv). Therefore, if a composite initial fee is payable that relates to the provision of goods and services that do not fall within the ambit of section 11(f)(iii) or (iv), no allowance is available under those sections.

If higher monthly fees (usually referred to as royalty payments in the franchise agreement – see **3.3**) are paid *in lieu* of an upfront lump sum initial fee, an apportionment of the monthly fee (royalty) will need to be made between the amount of the monthly fee relating to the grant by the franchisor to the franchisee of the right of use of the intellectual property and related business processes (the franchisee’s income-earning structure) and the ongoing cost of using that right (income-earning structure) to earn income. In other words, to the extent that the monthly fees relate to the acquisition by the franchisee of its income-earning structure, it will retain its character as an expense of a capital nature. Although the recurrent royalty payments relating to the acquisition by the franchisee of the right to the franchisor’s intellectual property and business processes are, in these specific circumstances, regarded as being of a capital nature, it cannot be said to be a “premium or consideration in the nature of a premium” as it remains a recurring royalty expense. The franchisee would in these specific circumstances not be entitled to claim an allowance on the capital cost under section 11(f)(iii) or (iv) even if the royalty payment related to the right of use of the intellectual property specified in those provisions.

In *New State Areas Ltd v CIR* it was held in relation to a payment of the purchase price of an asset in instalments that –²⁵

“...if it is incurred for the purpose of acquiring a capital asset for the business it is capital expenditure *even if it is paid in annual instalments*; if, on the other hand it is in truth no more than part of the cost incidental to the performance of the income producing operations, as distinguished from the equipment of the income producing machine, then it is a revenue expenditure even if it is paid in a lump sum.”

(Emphasis added)

The Supreme Court of Appeal in *BP Southern Africa (Pty) Ltd v C: SARS*²⁶ was called upon to decide whether *annual* royalty payments for the right to use the BP “licenced marks” (trade marks) and licensed “marketing *indicia*” (trade dress, colour schemes, designs and symbols) were revenue in nature and therefore deductible under section 11(a). The Tax

²⁴ Under section 102(1)(b) of the Tax Administration Act 28 of 2011, the burden is on the taxpayer to prove that an amount is deductible.

²⁵ 1946 AD 610, 14 SATC 155 at 170.

²⁶ 69 SATC 79 at 84.

Court²⁷ found that the royalties paid by BP Southern Africa related to the acquisition by the company of an income-earning structure and were accordingly of a capital nature and therefore not deductible under section 11(a). On appeal, the Supreme Court of Appeal held that the recurrent royalty payments were akin to rental payments and of a revenue nature (see **3.3.2**). The Supreme Court of Appeal arrived at its decision that the royalty payments were of a revenue nature based on the fact that –

- the purpose of the expenditure was the use – not ownership – of the intellectual property;
- the expenditure was of a recurrent nature; and
- no new asset for the enduring benefit of the taxpayer was created in consequence of the expenditure.

If an identifiable portion of the initial fee relates to expenditure that may be deductible under other provisions of the Income Tax Act, such as, for example, the acquisition of trading stock under section 11(a), the franchisee would have to prove such apportionment.

The discussion above demonstrates that the tax implications of each payment made under a franchise arrangement must be determined on their own particular facts.

With regard to the costs incurred by the franchisee in drawing up a franchise agreement, these costs will be linked to the establishment of the franchisee's income-earning structure (a capital asset) and will thus be non-deductible under the general deduction formula.

3.3 Royalty payments

A royalty in the context of a franchise arrangement is a recurring payment made by a franchisee to a franchisor for the ongoing use of the franchisor's intellectual property and business processes, the right to such use having been acquired against payment of the licence fee or initial fee.²⁸ Having secured the right to use the franchisor's intellectual property and business processes against payment of a licence fee or the initial fee, the franchisee now secures the ongoing use of this right against the periodic payment of royalties. In other words, the franchisee pays the franchisor the licence fee or initial fee to secure the right to join the "club". Thereafter, royalty payments are made by the franchisee in order to stay in and enjoy the benefits of this "club".

The franchisor retains ownership of its intellectual property and business processes at all times and it is merely the use of the property that is used by the franchisee. Royalty payments are normally calculated as a percentage of the franchisee's turnover or can be a fixed amount, and are payable weekly, monthly or annually.

3.3.1 Tax implications for franchisors

In *Vacu-Lug (PVT) LTD v COT*,²⁹ the sub-letting of a business lease was compared to an agreement in which *patent processes and trade marks were sub-licensed*. It was stated that the question that ultimately needs to be asked is –³⁰

"...whether or not 'the agreement' is to be regarded as similar in legal character to a 'cession of rights' or to a 'sub-letting of rights'. If it is more similar to a cession than to a sub-lease then

²⁷ ITC 1798 (2005) 68 SATC 9 (C).

²⁸ www.absa.co.za/Absacoza/Commercial/Industry/Franchising [Accessed 11 July 2016].

²⁹ 1963 (2) SA 694 (SR), 25 SATC 201.

³⁰ At page 206.

for the purpose of this argument the £5,000 would be capital; if on the other hand it is more similar to a sub-lease it would be income”.

In other words, the crucial inquiry is whether the transaction results in the franchisor deriving income from having disposed of (ceded) part of its intellectual property and business processes for a purchase price (capital), or from merely using (letting / sub-letting) the property and processes in carrying out a scheme of profit-making (revenue).

As with initial fees paid by a franchisee for the grant by the franchisor of the right of use of its intellectual property and business processes, the royalties are derived by the franchisor for the ongoing use (letting/sub-letting) of its intellectual property and business processes in a scheme of profit-making. Royalty payments do not generally relate to the disposal (cession) of a franchisor’s intellectual property and processes. Consequently, royalty payments will constitute gross income in the hands of the franchisor and will be taxable as such.

3.3.2 Tax implications for franchisees

The following clause is commonly found in franchise agreements:³¹

“Subject to the terms and conditions in this agreement, the Franchisor/Licensor hereby grants to the Franchisee/Licensee for the term of this Franchise/Licence Agreement, a personal, non-assignable, and non-exclusive license to use, exhibit, present, and advertise the Trade Marks solely in the operation of the business of the Franchisee/Licensee

The Trade Marks are and will remain the sole and exclusive property of the Franchisor/Licensor.”

The main purpose of this clause is to allow the franchisee to use, but not own, the intellectual property for the duration of the franchise agreement. Ownership thus remains with the franchisor throughout the term of the franchise agreement as well as upon the termination of the agreement. In return for the use of the intellectual property, the franchisee makes recurring payments to the franchisor. As mentioned, these payments are usually called royalty payments.

In order for royalty payments to be a deductible expense under section 11(a), the expenditure must not be of a capital nature. It must therefore be determined whether the royalty payment made by the franchisee can properly be regarded as part of the cost of performing its income-producing operations or as part of the cost of establishing, improving or adding to its income-producing structure.³² While the former constitutes expenditure of a revenue nature, the latter amounts to expenditure of a capital nature. In order to qualify for a deduction, the royalty payment must be incurred for the purpose of earning income. In addition, there must be a close link between the expenditure incurred and the income-earning operations of the franchisee.³³

The recurrent cost of acquiring the use of something which belongs to another is usually recognised as being of a revenue nature since it will be seen as forming part of the day-to-day running expenses of a taxpayer, that is, part of the cost of performing the taxpayer’s income-producing operations.

³¹ Daniel Erasmus “Royalties (franchise fees) and their deductibility” available online at www.fasa.co.za/documents/Royalties_DanielErasmus.pdf [Accessed 11 July 2016].

³² *New State Areas Ltd v CIR*, 1946 AD 610, 14 SATC 155 at 164.

³³ *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936 CPD 241, 8 SATC 13.

As mentioned above, the issue of the deductibility or otherwise of royalty payments made for the personal, non-exclusive and non-assignable use of the taxpayer's parent company's licensed trademarks and licensed business processes was considered in *BP Southern Africa (Pty) Ltd v C: SARS*.³⁴ In the court *a quo*,³⁵ the court held that the licence agreement entered into between the parties was calculated to preserve and enhance the taxpayer's market share and to secure a commercial advantage by virtue of the well-established reputation of the parent company. The royalty payments were accordingly held to be of a capital nature and therefore not deductible under the general deduction formula. The court *a quo* further noted that the royalty payments in these circumstances were akin to an initial fee paid to acquire the franchisor's intellectual property and business processes, and therefore of a capital nature. The Tax Court noted that the "fact that a payment is labelled as a royalty does not detract from the fact that it may be capital in nature" and also that expenditure of a recurrent nature can also "not detract from being capital in nature."³⁶

However, on appeal the Supreme Court of Appeal came to a different conclusion. The court held that the court *a quo*'s conclusion that the royalties were of a capital nature was unsustainable having due regard to the essential features of the licence agreement. The Supreme Court of Appeal noted that the royalty payments were made "to procure the use – not the ownership of - the intellectual property of another from its sole and rightful owner for the duration of the agreement," and concluded that the "recurrent cost of procuring the use of something which belongs to another is usually recognised as being of a revenue nature." The court concluded that royalty payments in the present case were "to all intents and purposes indistinguishable from the recurrent rent paid for the use of another's property."³⁷

On the basis of the decision in the BP Southern Africa case, recurrent royalty payments that are paid for the use of intellectual property will in most instances be regarded as being of a revenue nature and deductible under section 11(a).

Royalties may, depending on the terms of the franchise agreement, nevertheless be regarded as being expenditure of a capital nature in certain instances and thus non-deductible under section 11(a).

Examples of these instances include, but are not limited to –

- agreements under which the royalty payments that are made form part of the cost of creating the franchisee's income-earning structure, that is, the recurrent expenditure is directed towards the acquisition of a capital asset;³⁸ and
- royalty payments which, in reality, form part of the purchase price of the business.

As in most cases, the true nature of each transaction must be looked into in order to determine whether the expenditure attached to it is capital or revenue in nature.

³⁴ 69 SATC 79.

³⁵ ITC 1798 (2005) 68 SATC 9 (C).

³⁶ ITC 1798 (2005) 68 SATC 9 (C) at 23.

³⁷ 69 SATC 79 at 84.

³⁸ *C: SARS v Kajadas Cosmetics (Pty) Ltd*, 2002 (4) SA 709 (T), 64 SATC 200 at 203; ITC 1365 (1982) 45 SATC 27 (T) and ITC 1798 (2005) 68 SATC 9 (C).

3.4 Example – Taxation and/or deductibility of initial fees, licence fees and royalty payments

Example 1 – Taxation and/or deductibility of initial fees, licence fees and royalty payments

Facts:

Scenario 1: Following the success of X's Fine Dining restaurant, X embarked on a project in 2012 of expanding the business by creating a franchise chain. Before the commencement of the business, X licensed the intellectual property developed by it, which included the registration of a trade mark as well as the registration of a design. X's Fine Dining then flourished as a celebrated and respected franchise system.

Scenario 2: In January 2014, C entered into a 10-year franchise agreement with X. Under the terms of the agreement, C paid X an initial fee of R600 000 as consideration for the use of X's existing intellectual property and business processes, training methodology and assistance with the launch of the franchise outlet. The R600 000 initial fee included a licence fee of R200 000 relating to the grant of use by X to C of its intellectual property and knowledge relating to the use of the intellectual property. On 1 April 2014, C officially began trading as a restaurateur under the name of X's Fine Dining. In addition to the initial fee, C was required to make monthly royalty payments calculated at a rate of 10% of the monthly turnover of the franchise outlet. For the period of assessment dated 1 April 2014 – 31 March 2015, C's royalty payments amounted to R210 000.

Scenario 3: In January 2014, M entered into a 10-year franchise agreement with X. Being a friend of X, the lump sum initial fee of R600 000 was waived in favour of a monthly fee of R5 000.³⁹ A royalty payment, calculated at 10% of turnover, was also payable. On 1 April 2014, M officially began trading as a restaurateur under the name of X's Fine Dining. For the period of assessment dated 1 April 2014 to 31 March 2015, M's aggregate payments under the franchise agreement amounted to R230 000, that is, a royalty payment of R170 000 plus R60 000 additional payments paid by M *in lieu* of a lump sum initial fee.

Result:

a) Franchisor:

Scenario 1: The registration of its intellectual property was obtained with the objective of creating an income-earning structure. As such the registration expenditure represents money spent in creating or acquiring an income-producing concern and is therefore of a capital nature. The registration expense is therefore not deductible under section 11(a). The provisions of section 11(gB), however, apply and a deduction of this expense was allowable under that section (see 3.1).

Scenario 2: The initial fee of R600 000 received by X is of a revenue nature, being income earned in a scheme of profit-making through the productive use of its assets. This amount was therefore included in X's gross income and taxed accordingly. The royalty payments of R210 000 received from C was likewise included in X's gross income and taxed as such.

Scenario 3: The aggregate amount of R230 000 forms part of X's gross income and is taxable.

³⁹ Calculation of the R5 000: R600 000 / 10 years = R60 000 a year; R60 000 / 12 months = R5 000 per month.

b) Franchisee:

Scenario 2: The initial fee paid by C related to the initial support given by X in the establishment of C's franchise business, as well as the right of use of X's intellectual property and business processes, and was accordingly incurred with the intention of creating a capital asset (an income-earning structure) in the hands of the franchisee. This initial fee is therefore of a capital nature and not deductible under section 11(a).

As regards the licence fee of R200 000 incurred by C as part of the initial fee, that expenditure was similarly of a capital nature as held in ITC 1726.⁴⁰ As C is not engaged in any of the activities listed in section 11(gD) and the licence fee is not made to a national, provincial or local government, C is not entitled to claim a deduction for the cost of the licence under section 11(gD). However, given that the licence fee is paid in addition to the recurrent royalty payments paid for the use of intellectual property specified in section 11(f)(iii), and for imparting knowledge connected with such use as contemplated in section 11(f)(iv), the licence fee in these specific circumstances is arguably a "premium or consideration in the nature of a premium." as contemplated in those sections. The licence fee would therefore be deductible under sections 11(f)(iii) and (iv)

The recurrent royalty payments of R210 000 made by C qualify as a deductible expense under section 11(a) since the payments were part of the cost incidental to the performance of C's income-producing trade.

Scenario 3: The additional fees of R60 000 paid to M during the year of assessment *in lieu* of a lump sum initial fee would not have been deductible under section 11(a) as the expense was incurred by M for the purpose of acquiring an income-earning structure, as opposed to being part of the cost incidental to the performance of M's income-earning franchise operations. While the Supreme Court of Appeal in the *BP Southern Africa* case⁴¹ noted that a recurrent expense is a strong indicator of a revenue expense, it noted that this was "usually" the case and the court clearly recognised that there would be instances, such as those here, in which the recurrent expense (additional fee) creates an income-earning structure and is therefore of a capital nature. The remaining amount, that is, the royalty payments amounting to R170 000 would have qualified as a deduction under section 11(a).

3.5 Royalties paid on "tainted intellectual property"

Under section 23I, any expenditure incurred for the use or right of use or permission to use "tainted intellectual property"⁴² is not deductible⁴³ if the amount of expenditure does not constitute income in the hands of the person receiving the payment. This will however not be the case if the expenditure is deductible under section 11(gC), that is, expenditure incurred in acquiring the intellectual property listed in that section (see 3.1.1). In essence, "tainted intellectual property" is "intellectual property"⁴⁴ that is or was the property of a resident taxpayer, or in certain circumstances a "connected person" in relation to the resident taxpayer.

The rationale behind section 23I is to prevent South African-developed intellectual property from being exported to purchasers in low tax jurisdictions and then being licensed back to

⁴⁰ 64 SATC 236.

⁴¹ 69 SATC 79.

⁴² As defined in section 23I(1).

⁴³ Section 23I(2).

⁴⁴ Section 23I(1).

taxpayers in South Africa, thereby reducing the South African tax base. In the absence of section 23I this would be achieved by royalties being deductible in the hands of the resident licensee (franchisor or franchisee) but not taxable, or taxable at a low rate of tax, in the hands of the licensor (a foreign franchisor). This section applies to expenditure incurred on or after 1 January 2009.

In the context of a franchise arrangement, this means that section 23I will apply should a resident franchisor or franchisee (or a connected person in relation to the franchisor or franchisee) develop intellectual property and sell it to a non-resident who is not subject to South African income tax on the receipt of any amount derived on the exploitation of the intellectual property (that is, the receipts do not constitute “income” in the hands of the non-resident). Any expenditure incurred by a resident franchisor or franchisee in obtaining the use of or the right of use of or permission to use the now “tainted” intellectual property will not be deductible in the hands of the resident franchisor or franchisee under section 23I.

A deduction of this “tainted” expenditure will, however, be allowed under section 23I(2) to the extent that the amount of expenditure constitutes a proportional amount of the net income of a controlled foreign company which is included in the income of a resident under section 9D (the attribution of net income earned by a controlled foreign company to a resident).

In spite of the general prohibition against the deduction of “tainted intellectual property” expenditure under section 23I(2) in the circumstances mentioned above, section 23I(3)(a) permits a deduction equal to one-third of the “tainted” expenditure if the expense is subject to the South African withholding tax on royalties at a rate of 10%. A deduction equal to one-half of the “tainted” expenditure is permitted under section 23I(3)(b) if the expense is subject to the South African withholding tax on royalties at 15%.

While the withholding tax on royalties is imposed at a rate of 15%,⁴⁵ this rate may be reduced to 10% under a tax treaty. Importantly, in order for the allowable portion of the royalty to be deductible under section 23I(3), the royalty payment must be “payable” at the prescribed rates (10% or 15%). It follows that if South Africa is prohibited from imposing the withholding tax on royalties under the applicable tax treaty, or an exemption applies,⁴⁶ it cannot be said that the withholding tax on royalties is “payable” and the partial relief granted under section 23I(3) would therefore not apply. These relief provisions apply to royalties paid or that become payable on or after 1 July 2013.

Example 2 – Royalties paid to a foreign entity for “tainted intellectual property”

Facts:

Scenario 1: Franchisor X, a South African resident, is the developer of certain intellectual property. In 2014, X sold the intellectual property to a foreign entity, Z, resident in Country A. Z subsequently licensed the South African developed intellectual property back to X in return for regular royalty payments. X in turn sub-licensed the intellectual property to Franchisee Y in South Africa. In return for the use of the intellectual property, Y made royalty payments to X. Country A and South Africa have entered into a tax treaty that assigns exclusive taxing rights in relation to royalties to the country in which the beneficial owner of the intellectual property (Z) is resident – Country A in this instance.

⁴⁵ Section 49B.

⁴⁶ Section 49D.

Scenario 2: S, a resident franchisor, developed an invention and sold it to B, a resident of Country X. B filed a patent application in South Africa for this invention. B then licensed the patent to S's franchisee (Franchise JPT which is a resident of South Africa as well as a connected person in relation to S) in consideration for an annual licence fee of R600 000. No tax treaty exists between South Africa and Country X.

Result:

Scenario 1: The royalties payable by Y to X were included in X's gross income and are taxable as such. The royalties were also deductible in Y's hands as the royalties were not paid for the use of "tainted intellectual property" by Y. While Y is an "end user",⁴⁷ as the relevant South African developed intellectual property was never the property of Y or a connected person in relation to Y, or the property of Y at the time Y makes the royalty payments, the intellectual property licensed by X to Y is not "tainted intellectual property."

The issue that arises is whether the royalties payable by X to Z are deductible. In other words, is the intellectual property licensed by Z to X "tainted intellectual property"? While the intellectual property licensed by Z to X has been the property of X, provided X can demonstrate that it "derives income *mainly* by virtue of the grant of use or right of use or permission to use intellectual property or any corresponding invention",⁴⁸ X will not fall within the ambit of the definition of "end user". If X can demonstrate that it derives such income, Z's intellectual property will not constitute "tainted intellectual property". It follows that if X derives more than 50% of its income from royalties paid for the right of use of that and other intellectual property, it will be permitted to deduct the royalties paid by it to Z.

By contrast, if X is unable to demonstrate that it derives its income *mainly* (more than 50%) from licensing the use of intellectual property in general (not only from the sub-licensing of Z's intellectual property), then X would constitute an "end user" and as Z's intellectual property was previously owned by X, it will constitute "tainted intellectual property". Should that be the case, X would in the first instance be denied a full deduction of the royalties payable to Z under section 23I(2).

The question that then arises is whether any of the partial relief measures under sections 23I(3)(a) or (b) would apply.

While the withholding tax on royalties at a rate of 15% applies to the royalties payable by X to Z, South Africa is prohibited from imposing the tax under the tax treaty with Country A as Z is the beneficial owner of the intellectual property. As the withholding tax on royalties is not payable at either the 10% or 15% rate, in fact no withholding tax is "payable", the partial relief provided for in sections 23I(3)(a) and (b) would not apply and the full amount of royalties paid by X to Z would not be deductible under section 23I(3).

Scenario 2: While Franchise JPT is an "end user" as defined of the intellectual property licensed to it by B, it has never owned the intellectual property that it has the use of under the licensing arrangement. However, as B's intellectual property had been the property of S and Franchise JPT is a connected person in relation to S,⁴⁹ B's intellectual property is "tainted intellectual property".

⁴⁷ As defined in section 23I(1).

⁴⁸ Definition of "end user" in section 23I(1).

⁴⁹ A "taxable person" as defined in section 23I(1).

The issue is whether it can be said that the royalties derived by B constitute “income received by or accrued to” B as section 23I(2) applies only if the royalties derived by B do not constitute South African “income” (essentially gross income less exempt amounts). The royalties payable by Franchise JPT to B (a non-resident) are deemed to have been derived from a source in South Africa⁵⁰ and thus constitute South African gross income in B’s hands. However, the royalties received by B are exempt from tax under section 10(1)(l).⁵¹

As such, the royalties would not constitute “income” derived by B and Franchise JPT was in the first instance denied a deduction of the full royalty payments under section 23I(2). However, as no tax treaty exists between South Africa and Country X, the licence fees of R600 000 that were payable by Franchise JPT to B were subject to withholding tax at a rate of 15% (see 3.9). Consequently, Franchise JPT was entitled to claim a deduction limited to one-half of the licence fee under section 23I(3)(b). The amount that Franchise JPT may have deducted was therefore R300 000 (½ of R600 000). In the event that a tax treaty did exist between South Africa and Country X which reduced the withholding tax rate to 10%, Franchise JPT would have been entitled to a deduction of only one-third of the licence fee, namely R200 000 (⅓ of R600 000) under section 23I(3)(a).

Had the tax treaty reduced the rate to below 10%, that is, South Africa was prohibited under the treaty from imposing any tax on royalties derived by residents of Country X, the full licence fees would not have been deductible under section 23I(2).

3.6 Withholding tax on royalties

Any person that incurs a liability to pay a royalty to, or for the benefit of, a non-resident for the right of use in South Africa of certain intellectual property must pay a withholding tax to SARS as provided for under sections 49A to 49H. No withholding tax on the royalty amount will be payable if the amount is effectively connected with a permanent establishment of the non-resident in South Africa.

Section 49B provides for a withholding rate of 15%. A rate of 12% however applied to royalties that were paid, or that become due and payable, on or after 1 July 2013, but before 1 January 2015.

If the beneficiary resides in a country which has concluded a tax treaty with South Africa, the rate at which the withholding tax on royalties will be withheld may be reduced in whole or in part depending on the provisions of the specific treaty.

⁵⁰ Section 9(2)(d), read with the definition of “intellectual property” in section 9(1).

⁵¹ “10. Exemptions.—(1) There shall be exempt from normal tax—

- (l) the amount of any royalty as defined in section 49A which is received by or accrues to any person that is not a resident, unless—
 - (i) that person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the amount is received by or accrues to that person; or
 - (ii) the intellectual property or the knowledge or information in respect of which that royalty is paid is effectively connected with a permanent establishment of that person in the Republic;”

The person that incurs the liability to pay or withhold the tax must pay the tax to SARS by the last day of the month following the month in which the royalty is paid.⁵²

A discussion of what constitutes intellectual property subject to the withholding tax on royalties does not form part of this guide.

3.7 Early cancellation of a franchise agreement

Under section 7 of the Consumer Protection Act 68 of 2008, a franchisee may cancel a franchise agreement without cost or penalty within 10 business days after signing the agreement by giving written notice to the franchisor.

In the event that either the franchisor or franchisee should prematurely terminate a franchise agreement after the 10-day period, the party that terminates the agreement is normally required to pay the other party a sum of money in the form of compensation or as a penalty, depending on the circumstances of the cancellation and the specific provisions of the franchise agreement.

3.7.1 Compensation paid by a franchisor for early termination of a franchise agreement

A franchisor may cancel an agreement with a franchisee before termination of the franchise agreement for any number of reasons, such as the following:

- Cancellation of a franchise agreement by the franchisor in order to replace a current franchisee with a more competent franchisee.

In this instance, the replacement of a franchisee is carried out for the purposes of enabling a franchisor to put a particular franchise outlet to better use, thereby achieving enhanced income. In other words, the replacement is made so that the franchisor can better employ its business resources. The early termination payment made by the franchisor to the existing franchisee in these circumstances would therefore be regarded as being part of the cost of performing the franchisor's income-earning operations since the income-earning structure has already been established and will continue in existence. The expenditure in these circumstances will generally constitute a deductible expense under section 11(a).

- Cancellation of a franchise agreement by the franchisor in order to incorporate the franchisee's operations as part of its own operations.

In the event that a franchise agreement is cancelled with the intention of enabling the franchisor to incorporate the franchise operation in its own business, the payment made by the franchisor to the franchisee is regarded as being expenditure incurred for the acquisition of an income-producing structure rather than forming part of the cost of performing the franchisor's income-earning operations.⁵³ Consequently, the payment will represent expenditure of a capital nature and will not qualify as a deductible expense under section 11(a).

As regards the position of the franchisee in these circumstances, in determining whether the compensation amount received is subject to tax it needs to be determined whether the amount was paid to the franchisee to fill a hole in its profits (that is, of a revenue nature) or to fill a hole in its fixed capital assets (that is, of a capital nature).

⁵² Section 49F.

⁵³ *Seeff Properties CC v CIR*, 60 SATC 407 at 411.

It is trite law that an amount received as compensation for the loss, surrender or sterilisation of a fixed capital asset or of the whole or part of its income producing structure or machinery is a receipt of a capital nature.⁵⁴ The principles that emerge from the various cases dealing with compensation amounts was aptly summarised by Melamet J in ITC 1557⁵⁵ as follows:

“From the above authorities it would appear where the true nature of the transaction is that a company (presumably any taxpayer) is paid compensation for giving up, or closing down a particular branch of its business, and to retire from it, the compensation is of a capital nature. It matters not whether the business closed down is the whole business, or only a significant part of the business, and whether the closure and the payment of compensation is by way of agreement or under a compulsion. It makes no difference further that in law the ‘right’ that is sterilised had only a short duration, as long as the user had a reasonable expectation that it would be allowed to continue to use the right. It is immaterial whether the amount of the compensation is calculated by reference to profits lost or to be lost. Where a business is conducted under a contract or right, such as a lease or permit, it makes no difference whether the contract or permit is cancelled, or is merely sterilised, by way of an undertaking not to use it.”

A similar approach was adopted in *WJ Fourie Beleggings CC v C SARS*.⁵⁶ The court in this case held that a payment that is received for the permanent or sometimes temporary loss, deprivation or sterilisation of a capital asset of a taxpayer’s business will be regarded as a capital receipt. Conversely, if the payment merely relates to the temporary interference of the trader’s use of an asset, the receipt will generally be regarded as being of a revenue nature. During the course of his judgment CJ Musi J quoted with approval the following dictum in the English case of *Inland Revenue v Fleming & Co (Machinery) Ltd* (1951) 33 TC 57:

“When the rights and advantages surrendered on cancellation are such as to destroy or *materially* to cripple the *whole* structure of the recipient’s profit-making apparatus, involving the serious dislocation of the normal commercial organisation and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents the price paid for the loss or sterilisation of the capital asset and is therefore a capital and not a revenue receipt.”

While the method of calculation of the amount of compensation, for example, by reference to the loss of profits occasioned by the event giving rise to the payment of the compensation, is an important factor, it is settled law that it is not necessarily determinative of the nature of the receipt.⁵⁷

The rationale for this conclusion is that –⁵⁸

“it is a normal principle of valuation of a capital asset, whether it be land or the goodwill of a business or otherwise to use profits expected to be earned from the utilisation of the asset as a basis or starting point for the relevant calculations”.

⁵⁴ *CIR v Illovo Sugar Estates Ltd*, 1951 (1) SA 306 (N), 17 SATC 387; *Taeuber and Corssen (Pty) Ltd v SIR*, 1975 (3) SA 649 (A), 37 SATC 129 and *KBI v Transvaalse Suikerkorporasie Bpk*, 1987 (2) SA 123 (A), 49 SATC 11.

⁵⁵ (1992) 55 SATC 218 (T).

⁵⁶ 70 SATC 8 at 16.

⁵⁷ ITC 1341 (1980) 43 SATC 215 (T); *Taeuber and Corssen (Pty) Ltd v SIR*, 1975 (3) SA 649 (A), 37 SATC 129; ITC 1850,(2011) 73 SATC 228 (C) and *Stellenbosch Farmers’ Winery v C: SARS* 2012 (5) SA 363 (SCA), 74 SATC 235.

⁵⁸ Per McEwan J in ITC 1341 (1980) 43 SATC 215 (T).

The above principles were again confirmed in the seminal Supreme Court of Appeal decision in *Stellenbosch Farmers' Winery v C: SARS*⁵⁹ dealing with the taxation of the receipt of compensation for the premature cancellation of a distribution arrangement.

Therefore, to the extent that a franchisee receives a compensation payment from a franchisor for the early termination of the franchise agreement, the amount representing the compensation would, in all probability, be regarded as a receipt of a capital nature if it can be said that a substantial part of the income-producing structure of the franchisee has been sterilised by the early termination.

3.7.2 Compensation paid by a franchisee for early termination of a franchise agreement

Similar to the position above, a franchisee may prematurely terminate a franchise agreement for any number of reasons, most often because of unforeseen financial difficulties. The franchisee would in these circumstances most probably be required to pay compensation to the franchisor. The franchisee will only be entitled to a deduction of the expense if it is able to show that the expense was incurred in the production of its income and that the risk of the payment occurring was so closely connected with the business operations that it was necessarily incidental to the carrying on of that business.⁶⁰ The expense must also not be of a capital nature.

The compensation paid by the franchisee to the franchisor in these circumstances cannot be said to have been incurred by the franchisee in the course of its ordinary income-earning operations, but rather because of the discontinuance of its business operations (income-earning structure). This expenditure would accordingly, in most instances, be properly classified as being capital in nature and thus not deductible under section 11(a). Furthermore, the provisions of section 23(g) will prevent any deduction as the expense will be regarded as money not laid out or expended for the purposes of trade.

Importantly, the capital costs incurred in acquiring the right of use of the franchisor's intellectual property and business processes (whether a licence fee – see 3.1 or an initial franchise fee – see 3.2) must be taken into consideration upon the termination of the franchise. Upon termination, these costs will form part of the base cost of the asset (the franchisee's rights under the franchise agreement) disposed of by the franchisee for CGT purposes.

The principles discussed above relating to the receipt of compensation by a franchisee from a franchisor as a result of the early termination of the franchise arrangement will apply equally when a franchisor receives a sum of money from a franchisee owing to the early termination of the franchise agreement by the franchisee. That is, if the compensation was paid to fill a hole in the profits of the franchisor owing to the cessation of the franchisor's royalty income, the money will be regarded as being of a revenue nature and will thus form part of the franchisor's gross income. However, if the money was paid by the franchisee to the franchisor to fill a hole in the franchisor's fixed capital assets, such as cessation of a significant part of the franchisor's income-earning structure, the money will be of a capital nature.⁶¹

⁵⁹ 2012 (5) SA 363 (SCA), 74 SATC 235.

⁶⁰ *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936 CPD 241, 8 SATC 13. See also *CIR v Genn and Co (Pty) Ltd*, 1955 (3) SA 293 (A), 20 SATC 113.

⁶¹ ITC 1850 (2011) 73 SATC 228 (C).

By way of illustration, should a franchisor receive compensation from a franchisee for the early cancellation of a franchise, but the franchisor is nevertheless able to replace that franchisee almost immediately with another franchisee using the same business infrastructure used by the previous franchisee, the compensation cannot be said to relate to the franchisor's income-earning structure (capital), but rather its income-earning operations (revenue) as the franchisor's income-earning structure in effect remains in existence.

Each termination should however be evaluated on its own merits before deciding on the tax treatment of an expense.

3.8 Penalties for breach of contract

Franchise agreements may occasionally contain a penalty clause that is triggered when a party breaches a provision in the agreement or fails to meet certain predetermined milestones. A franchisee that does not reach the required turnover for a particular month may, for example, be required to make a penalty payment to the franchisor. In this case, the expense must be evaluated in light of the requirements of the general deduction formula when deciding whether a deduction will be allowed in the hands of the franchisee. Generally, a penalty of this nature will be deductible as the expense is so closely connected to the franchisee's income-earning operations that it is inseparable from those operations. The penalty in these circumstances will not have been incurred in relation to the franchisee's income-earning structure, nor does it give rise to an enduring benefit.

As regards the receipt of the penalty payment by the franchisor in these circumstances, the receipt will, in most instances, be included in its gross income. Each penalty payment will, however, need to be analysed based on the circumstances giving rise to the payment of the penalty and no single solution applies in all cases.

3.9 Renewal fees

Once a franchise term has ended, franchisors often grant franchisees a chance to renew or extend the franchise agreement against payment of a renewal fee. The renewal fee is similar to the initial fee paid at the commencement of the franchise agreement.

The tax treatment of an initial franchise fee as discussed in 3.1 will apply to a renewal fee as it is of a similar nature.

3.10 Advertisement fees

In most franchise systems, the franchisor undertakes to manage an advertising fund and the franchisee is often required to make a contribution to the fund. The fund is generally used to fund advertising and marketing campaigns in promotion of the franchise chain as a whole or a particular branch. In certain instances, the fees are also used to reimburse the franchisor for the costs of administering the advertising fund.

3.10.1 Tax implications for franchisors

Should the advertising fund be constituted as a separate person for income tax purposes, such as a trust or company, the advertising fees that the person receives will constitute gross income. The person should, depending on the nature of the expenditure incurred, then be entitled to a deduction of any expenditure incurred in carrying out its mandate of promoting the products, services and activities of the franchise, whether under section 11(a) or as a capital allowance.

In most instances however, the advertising fees are paid to the franchisor. While the franchisor may be obliged under an agreement with the franchisees to expend the advertising fees received by the franchisor on advertising and promoting the franchise, the fees will nevertheless have been received by the franchisor and would accordingly constitute gross income in its hands. As in the case above, the franchisor will in all probability be entitled to a tax deduction, either under section 11(a) or as a capital allowance, of any expenditure incurred by the franchisor on advertising or promoting the franchise.

3.10.2 Tax implications for franchisees

In order for advertising expenditure to be deductible, it has to be expended in the production of the franchisee's income and must be of a revenue nature. Further, the expenditure must be connected with the advertising of a business already in existence.

The question that must be considered is whether the expenditure was made with a view to bringing into existence an asset or an advantage for the enduring benefit of the franchisee's trade. Should this be the case, it will be an expense of a capital nature and therefore will not be deductible. However, a recurring cost which normally does not create an enduring benefit is likely to be of a revenue nature and will be deductible under section 11(a).

Being a recurring expense that would ordinarily not give rise to an asset of enduring benefit, advertising related expenditure would, in most circumstances, constitute expenditure of a revenue nature and as such be deductible under section 11(a).

3.11 On-going training fees

Before the launch of a new franchise outlet, the franchisor will usually provide a training programme to the staff and management of the franchisee so as to familiarise them with the franchisor's products and services. This initial training is followed by on-going training relating to new developments in the market as well as educating the franchisee on ways to be more cost-effective in the running of the business. These programmes endeavour to instruct the franchisee on how to productively run a franchise outlet.

3.11.1 Tax implications for franchisors

The training fees received by the franchisor will be gross income and will be taxable as such. The franchisor should however be entitled to a deduction under section 11(a) of any expenditure incurred by the franchisor in providing the requisite training.

3.11.2 Tax implications for franchisees

Training fees are a necessary expense as they enable the franchisee to operate more efficiently and to increase or maintain its revenue. The fact that a franchisee trades more effectively does not convert the expenditure into a capital expense.⁶²

Training fees can thus properly be regarded as a cost incurred in order to generate income and will be a deductible expense in the hands of a franchisee under section 11(a).

3.12 Capital gains tax

CGT is not a separate tax, but is part of normal income tax and is payable on the taxable capital gain derived by a taxpayer on the disposal of assets.⁶³ A capital gain arises when the

⁶² *Mobile Telephone Networks Holdings (Pty) Ltd v C: SARS*, (2011) 73 SATC 315 at 324.

⁶³ Eighth Schedule.

“proceeds” from the disposal of an asset exceed the “base cost” of the asset. South African resident companies and individuals are subject to CGT on the disposal of their assets on a world-wide basis.

By contrast, non-residents are subject to South African CGT on the disposal of only the following assets:

- Immovable property situated in South Africa, or any interest or right of whatever nature to or in immovable property situated in South Africa; and
- Any asset which is attributable to a permanent establishment of the non-resident in South Africa.

An “interest in immovable property situated in South Africa” includes equity shares held by the non-resident in any company, ownership or right to ownership of the non-resident in any entity or a vested interest of the non-resident in the assets of any trust if –

- 80% or more of the market value of those equity shares, ownership or right to ownership or vested interest, as the case may be, at the time of disposal thereof is attributable directly or indirectly to immovable property held otherwise than as trading stock; and
- in the case of a company or other entity, that person (whether alone or together with any connected person in relation to that person), directly or indirectly, holds at least 20% of the equity shares in that company or ownership or right to ownership of that other entity.

The tax treaties entered into between South Africa and other countries may, however, provide that South Africa is prohibited from imposing any tax on specified capital gains derived by the residents of the other country.

Thus, for example, the Mauritius tax treaty provides that South Africa may only tax capital gains derived by residents of Mauritius from the alienation of –

- immovable property situated in South Africa;
- movable property forming part of a permanent establishment situated in South Africa; and
- shares deriving more than 50% of their value from immovable property situated in South Africa.

All other capital gains derived by a resident of Mauritius are only taxable in Mauritius.

The sale of the franchisee’s interest in the legal entity that carries on the franchise business will be subject to CGT since it constitutes the disposal of an asset (e.g. shares in the company that carries on the franchise business). The “proceeds” derived by the franchisee on disposal of the franchisee’s interest in the entity and the “base cost” applicable to the franchisee’s interest have to be determined. For an asset acquired on or after 1 October 2001 this base cost is determined under paragraph 20 of the Eighth Schedule, which includes the cost of acquiring or creating the asset. Apart from the sale of franchisee’s interest in the entity, the sale of a licence by the franchisor might also trigger a disposal for CGT purposes. Attention should also be paid to paragraph 33 of the Eighth Schedule which relates to the part-disposal of an asset.

If a franchise business is disposed of, and not the legal entity that carries on the franchise business, the transaction has the legal effect of the disposal of the different assets used for

carrying on the franchise business. The CGT consequences that arise as a result of the disposal of each of these various assets must be determined individually. See the *Comprehensive Guide to Capital Gains Tax* (Issue 5) for further information. For more information on small businesses, see the *Tax Guide for Small Businesses* (2014/15).

In the event that the franchise business (not the legal entity that carries on the franchise business) that is disposed of qualifies as a “small business”, paragraph 57 of the Eighth Schedule will apply. A “small business” is defined⁶⁴ as a business of which the market value of all its assets, at the date of disposal, is less than R10 million. Liabilities are not taken into account and all assets are accounted for regardless of their nature - with the exception of personal assets that do not form part of the business of a sole proprietor. Under paragraph 57(2) a *natural person* (that is, not a trust or company) must disregard any capital gain derived in consequence of the disposal of this person’s interest in the active business assets of a small business, or any interest in the small business itself, provided the natural person has attained the age of 55 years; or the disposal is in consequence of ill-health, other infirmity, superannuation or death of the natural person. However, the sum of the amounts to be disregarded by a natural person may not exceed R1,8 million during that natural person’s lifetime.

3.13 Restraint of trade payments

In an attempt to protect the rights of the franchisor, restraint of trade provisions are often included in franchise agreements. These provisions generally relate to the protection of the intellectual property rights held by the franchisor, such as customer lists, know-how, trade secrets and other confidential information that would result in detrimental consequences for the franchisor should the information be divulged. At times, restraint of trade payments also seek to prevent a person from exercising a trade, profession or occupation in a specified geographical area for a defined period of time in return for compensation.

Generally, payments received for restraint of trade are of a capital nature as they represent a form of compensation received for the surrender or sterilisation of a capital asset. Additionally, section 23(l) stipulates that no deduction may be granted on an expense incurred for the payment of any restraint of trade, except as provided for under section 11(cA). A restraint of trade payment will be deductible under section 11(cA) if it is paid to, amongst others, a *natural person* and the payment is or will be income in the hands of the natural person. The restraint of trade payment may, however, be deducted only in equal instalments over the years of assessment that the restraint applies, or one-third in each of the present and succeeding two years of assessment, whichever is the lesser.

A restraint of trade payment will be treated as income in the hands of a natural person only if it falls within the scope of paragraph (cB) of the definition of “gross income”. A restraint of trade payment received by a natural person will constitute gross income under paragraph (cB) if it relates to the person’s present, past or future employment or the holding of an office.

For more information on restraint of trade payments, see Interpretation Note 7 dated 27 March 2002 “Restraint of trade payments”.

⁶⁴ Paragraph 57(1) of the Eighth Schedule.

4. Conclusion

This guide is intended to provide clarity regarding some of the general issues pertaining to franchisors and franchisees in South Africa. Note that each case has to be considered on its own merits when determining the taxability of a franchisor and a franchisee. The terms and conditions of the franchise agreement, as well as the manner in which payments are construed, will be important in determining the tax implications of the different types of amounts received, or expenses incurred, by franchisors and franchisees.