



Guide on the Taxation of Franchisors and Franchisees

Income Tax

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Preface

This guide considers the income tax implications of specified income received and specified 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**. Unless indicated otherwise, the latest issues of these documents should be consulted.

For more information you may –

- visit the SARS website at **www.sars.gov.za**;
- visit your nearest SARS branch after making an appointment via the SARS website;
- have a virtual consultation with a SARS consultant by making an appointment via the SARS website;
- 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 4.30pm South African time).

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Contents

Preface	i
Glossary	1
1. Introduction	1
2. The franchise arrangement	1
3. Taxation of franchisors and franchisees	2
3.1 General principles	2
3.2 Creation or acquisition of intellectual property	5
3.2.1 Tax implications for franchisors: deduction for costs incurred in creating or acquiring intellectual property	5
3.2.2 Tax implications for franchisors and franchisees: drawing up legal agreements for utilisation of the intellectual property created or acquired.....	7
3.3 Upfront fees.....	7
3.3.1 Tax implications for franchisors: receipt of an upfront fee	8
3.3.2 Tax implications for franchisees: payment of the upfront fee	9
a) Licence fee and/or an initial fee	9
b) Tax implications under section 11(f)	11
c) Higher royalty payments <i>in lieu</i> of upfront payments	13
d) Other	14
3.4 Royalty payments	14
3.4.1 Tax implications for franchisors	15
3.4.2 Tax implications for franchisees.....	15
3.5 Royalties on “tainted intellectual property”	17
3.6 Withholding tax on royalties.....	21
3.7 Early cancellation of a franchise agreement	21
3.7.1 Compensation paid by a franchisor for early cancellation of a franchise agreement	21
3.7.2 Compensation paid by a franchisee for early cancellation of a franchise agreement	23
3.8 Penalties for breach of contract.....	24
3.9 Renewal fees.....	25
3.10 Advertisement fees.....	25
3.10.1 Tax implications for franchisors	25
3.10.2 Tax implications for franchisees.....	25
3.11 Training fees	26
3.11.1 Tax implications for franchisors	26
3.11.2 Tax implications for franchisees.....	26
3.12 Capital gains tax.....	26
3.13 Restraint of trade payments	28
4. Conclusion	28

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;
- “**taxpayer**” and “**person**” are used interchangeably;
- “**Trade Marks Act**” means the Trade Marks Act 194 of 1993; and
- any other word or expression bears the meaning ascribed to it in the Income Tax Act.

1. Introduction

The franchise industry in South Africa is a major contributor to the South African economy. There is a need for clarity concerning the tax implications that arise in relation to franchise arrangements, in particular, the income tax treatment of specified income received or accrued and specified expenditure incurred by franchisors and franchisees under franchise agreements. The aim of this guide is thus to assist in clarifying uncertainties that may arise on the application of the income tax laws to a franchise arrangement.

This guide focuses mainly on transactions between franchisors and franchisees that are resident in South Africa.

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 Franchise 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-franchising-terms-and-definitions [Accessed 16 August 2021].

- **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 contract between the franchisor and franchisee which tells each party what each is supposed to do.
- **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 enables the franchisee to sell the franchisor's products but does not involve the franchisor providing the franchisee with its method of conducting business. This guide is focused on the business format franchise arrangement (hereinafter referred to as a "franchise"), however, many of the concepts examined in this guide will often also apply to a product distribution franchise arrangement and other variations of franchise arrangements.

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

3.1 General principles

A franchisor's income and a franchisee's expenditure can, respectively, include a wide range of amounts received or accrued, and incurred, which are stipulated in the franchise agreement. A franchisor, for example, may receive payments such as initial fees, renewal fees and royalties from a 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 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.

This section of the Guide provides commentary on some of the general principles and sections which underlie the taxability or tax deductibility of many amounts that are received by or accrue to, or are paid or incurred by, franchisors and franchisees. Some of these principles and sections are also applied in the commentary in **3.2** to **3.11** below which explains the tax treatment of specified types of income and expenses relevant to franchisors, franchisees and franchise agreements.

² www.fasa.co.za/what-is-franchising/ [Accessed 16 August 2021].

A receipt of an amount by a franchisor or franchisee 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. This definition also includes a number of specified amounts irrespective of whether the amount is capital or revenue in nature.

The courts have developed a number of tests for determining the capital or revenue nature of receipts and accruals. For example, there is the “tree versus the fruit” test, and the realisation of a capital asset versus the making of a gain in carrying out a scheme of profit-making test.

In *CIR v Visser*, Maritz J stated the following:³

“If we take the economic meaning of ‘capital’ and ‘income’ the one excludes the other. ‘Income’ is what ‘capital’ produces, or is something in the nature of interest or fruit as opposed to principal or tree.”

In *Californian Copper Syndicate (Limited and Reduced) v Harris (Surveyor of Taxes)*,⁴ which was quoted with approval in *Overseas Trust Corporation Ltd v CIR*,⁵ Clerk LJ stated the following:

“... the question to be determined being – [i]s the sum of gain that has been made a mere enhancement of value by realising a security, or is it a gain made in an operation of business in carrying out a scheme for profit-making?”

See the *Comprehensive Guide to Capital Gains Tax* for detail on the different tests.

All amounts that a 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.

Often for expenses or losses to qualify for a deduction from a franchisor’s or franchisee’s “income”,⁶ the requirements set out in section 11(a) read with section 23(g) must be complied with.

Under these sections the expense or loss must –

- be actually incurred;
- be in the production of the franchisee’s or franchisor’s income;
- be laid out or expended for the purposes of trade; and
- not be of a capital nature.

Expenses and losses must generally (see section 23H below) be claimed as a deduction under section 11(a) read with section 23(g) in the year of assessment in which the expense or loss is actually incurred.

³ 1937 TPD 77, 8 SATC 271 at 276.

⁴ 41 Sc LR 694, 5 TC 159 at 166.

⁵ 1926 AD 444, 2 SATC 71.

⁶ “Income” is gross income after deducting any amounts exempt from tax.

The capital or revenue nature of the expenditure will often determine whether the expenditure qualifies for a deduction under section 11(a) provided that all the other requirements of the section are met and a more specific section is inapplicable⁷ or whether it potentially qualifies for a capital allowance over a number of years (considered below with reference to specific types of expenses).

The courts have developed a number of tests for determining the capital or revenue nature of expenditure.⁸ The cases below highlight two important principles.

In *New State Areas Ltd v CIR* Watermeyer CJ, after reviewing a number of decisions of the courts in the United Kingdom, said:⁹

“The conclusion to be drawn from all of these cases seems to be that the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; 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.”

In *CIR v George Forest Timber Company Ltd*, Innes CJ held as follows:¹⁰

“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)

If 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, that deduction may be limited under section 23H if the expenditure relates to –

- goods or services, all of which will not be supplied or rendered to the person during that year of assessment, or
- any other benefit, the period to which the expenditure relates extends beyond that year of assessment.

Section 23H essentially provides for the deferral of a deduction of 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.

Most amounts which were allowed to be deducted or set off in a current or a previous year of assessment and which have been recovered or recouped during the current year of assessment must be included in a taxpayer’s income in the current year of assessment.¹¹

⁷ Section 23B(3).

⁸ See the *Comprehensive Guide to Capital Gains Tax* for detail on the different tests.

⁹ 1946 AD 610, 14 SATC 155 at 170.

¹⁰ 1924 AD 516, 1 SATC 20 at 26. This approach has subsequently been reaffirmed on numerous occasions by our courts.

¹¹ See, for example, section 8(4)(a).

Section 24C¹² provides for the deduction of an allowance if a taxpayer's income for the particular year of assessment includes an amount which has been received by or accrued to the taxpayer in terms of a contract and all or part of that amount will be used to finance "future expenditure"¹³ which will be incurred by the taxpayer in performing the taxpayer's obligations under that contract. An allowance claimed under section 24C must be reversed in the subsequent year of assessment.

In *C: SARS v Big G Restaurants (Pty)*¹⁴ the taxpayer was a franchisee that operated restaurants under various franchise agreements with the Spur Group (Pty) Ltd (the franchisor). Under the franchise agreement the franchisee was required to upgrade and refurbish its restaurants at reasonable intervals determined by the franchisor and subject to certain approvals from the franchisor. The taxpayer sought to claim an allowance under section 24C for these future upgrade and restoration costs. Applying a narrow meaning of "in terms of" used in section 24C(2), the Court held that the income-earning and obligation-imposing contract must be the same contract and that the franchisee did not receive any income under the franchise agreement. The Court stated that even though a contract is useful or necessary to enable a taxpayer to earn income, it does not mean that the taxpayer's income is earned "in terms of" such contract. Accordingly, the requirements in section 24C were not met and section 24C was held not to apply. SARS also contended that there was no future expenditure as it was conditional. However, having found that the income requirement had not been met, it was not necessary for the Court to decide on this aspect. On appeal the Constitutional Court¹⁵ held that two or more contracts may be so inextricably linked that they meet the requirement of "sameness",¹⁶ however, on the facts of Big G's case the Constitutional Court found the sameness requirement was not met and the section was inapplicable.¹⁷

3.2 Creation or acquisition of intellectual property

3.2.1 Tax implications for franchisors: deduction for costs incurred in creating or acquiring intellectual property

In order to determine whether the cost incurred by a franchisor in developing or acquiring intellectual property qualifies as a deductible expense under section 11(a) (see **3.1**), the nature of the expenditure as well as the purpose of the expenditure must be evaluated. In determining whether the expenditure is of a capital or revenue nature it is necessary to differentiate between expenses incurred to create an income-producing structure and those incurred to operate the income-producing structure.

The costs incurred by a franchisor in –

- obtaining a patent;
- devising or developing an invention;¹⁸

¹² See Interpretation Note 78 "Allowance for future expenditure on contracts" for detail on section 24C.

¹³ As defined in section 24C(1).

¹⁴ 2019 (3) SA 90 (SCA), 81 SATC 185. The taxpayer appealed the SCA judgment in the Constitutional Court (see below).

¹⁵ *Big G Restaurants (Pty) Ltd v CSARS* 2020 (6) SA 1 (CC), 82 SATC 403.

¹⁶ "Sameness" referring to the requirement that the income-earning and obligation-imposing contract must be the same contract.

¹⁷ For completeness we note that in *Clicks Retailers (Pty) Limited v CSARS* CCT07/20, the Constitutional Court gave further consideration to the meaning of two or more contracts being so inextricably linked that they satisfy the requirement of "sameness".

¹⁸ See Interpretation Note 50 "Deduction for Scientific or Technological Research and Development" for more information on inventions in relation to section 11D.

- creating or producing a design, copyright or any property of a similar nature;
- registering a trademark, trade name or design;
- restoring or extending any patent;
- extending the registration period for a design; and
- renewing 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 and not in operating the income-producing structure.

Subject to certain requirements, the expenses referred to above could, however, be deductible under other sections in the following circumstances:

- Section 11(gB) provides for the deduction of expenditure actually incurred during the year of assessment in obtaining the granting, the 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% or 10% (depending on the type of asset) a year of the expenditure actually incurred during years of assessment commencing on or after 1 January 2004¹⁹ to acquire (otherwise than by devising, 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;
 - other property of a similar nature (other than trade marks as defined in the Trade Marks Act); or
 - knowledge essential to the use of such invention, patent, design, copyright, other property or the right to have such knowledge imparted.
- Section 11D provides various deductions for specified scientific or technological research and development including, for example, creating or developing an invention or functional design, as defined.²⁰ Research and development for purposes of section 11D specifically excludes the creation or enhancement of trademarks or goodwill.

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

¹⁹ 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).

²⁰ See section 11D for detail.

Example 1 – Deductibility of expenditure incurred in the registration of intellectual property by a franchisor

Facts:

Following the success of X's Fine Dining Restaurant, X embarked on a project in 2020 of expanding the business by creating a franchise chain. X's Fine Dining flourished as a celebrated and respected franchise chain. Before the commencement of the franchise 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.

Result:

The registration of X's intellectual property was obtained with the objective of creating an income-earning structure. As such, the registration expenditure represented money spent in creating or acquiring an income-producing concern and was therefore of a capital nature. The registration expense was thus not deductible under section 11(a). However, section 11(gB) applied since this section specifically provides for the registration of intellectual property and a deduction of this expense was thus allowable under that section.

3.2.2 Tax implications for franchisors and franchisees: drawing up legal agreements for utilisation of the intellectual property created or acquired

Situations may arise in which a franchisor may bear the costs of drafting a franchise agreement. In these cases, 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 which includes its intellectual property and business processes. The fee is consequently regarded as being of a revenue nature and thus deductible under section 11(a).

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 which is a capital asset and will thus be non-deductible under section 11(a).

3.3 Upfront fees

An upfront fee, comprising of a licence fee and/or an initial fee, is usually paid by a franchisee to a franchisor to enable the franchisee to use the franchisor's intellectual property and business processes including operational standards and procedures. This fee is generally paid before commencement of trade by the franchisee. The bundle of rights that is acquired by the franchisee relates not only to the acquisition of the right of use of the franchisor's intellectual property and business processes (licence fee), but also a myriad of other goods and services necessary for the launch and continuing operation of the franchise (initial fee).

As noted by the International Franchise Association, under a usual franchise arrangement –²¹

“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...”

(Emphasis added)

²¹ www.franchise.org/faqs/basics/what-is-a-franchise [Accessed 16 August 2021].

Therefore, the upfront fee generally does not relate only 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 –

- 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 upfront fee rate applies since the fee varies between the different types of franchises and in some instances between franchises of the same type. For example, some agreements will provide for separate fees to be paid as a licence fee and an initial fee or a higher royalty payment could be paid to secure the rights to operate the franchise *in lieu* of an upfront payment.

The income tax consequences of some of these upfront fees are considered below.

3.3.1 Tax implications for franchisors: receipt of an upfront fee

The upfront fee paid by a franchisee to the franchisor is usually paid in the form of an upfront lump sum payment. The upfront fee is paid by the franchisee for the acquisition of the right to use the franchisor's intellectual property and business processes as well as the right to trade in an exclusive use area.²² The upfront fee is thus regarded as the product or fruit derived by a franchisor from putting its capital assets to productive use²³ and is therefore not regarded as a receipt of a capital nature. An upfront fee received by a franchisor will consequently form part of the gross income²⁴ of the franchisor.

In ITC 1738²⁵ an initial fee was paid to the franchisor for the use of the franchisor's "identifications" such as the trademark, designs, advertising matter and signage as well as the skills, know-how and technical information relating to planning, setting-up and operating the franchisor's know-how. SARS argued that the initial fee was gross income as it was received as consideration for granting the franchisee a temporary right to use the franchisor's asset and it was therefore the fruit received from putting its capital asset to productive use. It was also submitted that the fruit was a gain made by an operation of business in carrying out a scheme for profit making. The court agreed and 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 such, the court held that it was unnecessary to decide if

²² 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.

²³ ITC 1738 (2000) 65 SATC 37 (C) at 42.

²⁴ As defined in section 1(1).

²⁵ (2000) 65 SATC 37 (C).

the initial franchise fee fell within the ambit of paragraphs (g) or (gA) of the definition of “gross income”.

Paragraph (g) includes any premium or consideration in the nature of a premium for, amongst other things, the *use of or right of use of* any patent, design, trade mark or copyright, as defined in the specified Acts or for the use of any model, pattern, plan, formula or process or any other property or right of a similar nature in gross income. 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. In *CIR v Butcher Bros (Pty) Ltd*²⁶ 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.²⁷ 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.

Paragraph (gA) provides that any amount received or accrued by a taxpayer as consideration for imparting, or undertaking to impart, any scientific, technical, industrial or commercial knowledge or information, or rendering, or undertaking to render, any assistance or service in connection with the application or utilization of such knowledge or information, constitutes gross income. Under this paragraph, the consideration need not be in the nature of a premium.

An upfront 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 generally, even if it did not constitute gross income under the general inclusion,²⁸ constitute gross income under either paragraph (g) or (gA) of the definition of “gross income”.

3.3.2 Tax implications for franchisees: payment of the upfront fee

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

(a) Licence fee and/or an initial fee

The amount expended by a franchisee in obtaining a licence for the right of use of the franchisor’s intellectual property and business processes is generally paid in addition to the royalty payments that a franchisee is required to make for the continued use of the relevant intellectual property and business processes granted under the licence agreement (see **3.4**).

In ITC 1726²⁹ it was held that a licence granted by the State for a renewable period of 15 years to enable the taxpayer to conduct a non-exclusive cellular service was a right to conduct the specific undertaking and further that it was of such an enduring nature that the licence fee was of a capital nature and therefore not deductible under section 11(a). 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”,³⁰ 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

²⁶ 1945 AD 301, 13 SATC 21.

²⁷ See Interpretation Note 109 “Lease Premiums”.

²⁸ As held in ITC 1738 (2000) 65 SATC 37 (C).

²⁹ (2000) 64 SATC 236 (G) at 240.

³⁰ At 241.

to maintain the advantage of having the licence and was accordingly revenue in nature and deductible under section 11(a).

In *C: SARS v I-Net Bridge (Pty) Ltd*³¹ the taxpayer had made an advance payment of 5 years of annual licence fees. The upfront 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 by I-Net Bridge to its customers. The taxpayer argued that the advance payment of the annual licence fees was paid for trading stock (the data) that was subsequently disposed of to its customers. SARS argued 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 SARS’s argument, 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 as follows:³²

“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*”.

(Emphasis added)

As will be apparent, the facts of the *I-Net Bridge* case were unique involving the acquisition of trading stock (data) which was subsequently disposed of to its customers. 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 a lump sum upfront licence fee paid by a franchisee to secure the use of the franchisor’s intellectual property and business processes is akin³³ to the licence fee paid by the taxpayer in ITC 1726. 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 upfront licence fee is accordingly of a capital nature and not deductible under section 11(a).

The above will also apply when a payment relating to an upfront initial fee is made. The franchisee’s aim in entering into a franchise agreement with a franchisor and expending an amount in the form of a composite upfront initial fee is to establish an income-producing concern or structure. This fee is consequently of a capital nature and not deductible under section 11(a). If the “test” formulated in the *CIR v George Forest Timber* case (see 3.1) is

³¹ (2010) 73 SATC 141 (NG).

³² At 147.

³³ Of similar character.

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).

In the event that the payment relating to licence fees or initial fees are made in instalments, it will also be non-deductible. In ITC 353³⁴ 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. Similarly in *C: SARS v Kajadas Cosmetics (Pty) Ltd*³⁵ an annual fee for exclusive distribution rights was held to be capital in nature, since it created the taxpayer's income-earning structure.

(b) Tax implications under section 11(f)

Depending on the facts, a franchisee may meet all the requirements of section 11(f) and therefore qualify for a deduction for all or part of an upfront fee paid to the franchisor.

Section 11(f) provides an allowance for any premium or consideration in the nature of a premium paid by a taxpayer for, amongst others, –

- “(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
- (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”.

The allowance is calculated as a portion of the amount of the premium or consideration in the nature of a premium divided by the number of years (limited to 25 years) for which the franchisee is entitled to use the specified intellectual property.³⁶

Some of the requirements of section 11(f) are discussed below.

The term, “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*”.³⁷ (Emphasis added)

A lump sum upfront licence fee or initial 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
- imparting, or undertaking to impart, knowledge in relation to the use of such intellectual property under section 11(f)(iv),

would constitute a “premium or consideration in the nature of a premium” if such fees are paid in addition to, or in lieu of, any recurrent consideration (for example, in context, an annual licence fee or a royalty) payable by the franchisee to the franchisor for the continued use of

³⁴ (1936) 9 SATC 82(U).

³⁵ 2002 (4) SA 709 (T), 64 SATC 200.

³⁶ Paragraph (aa) and (cc) of the proviso to section 11(f). See Interpretation Note 109 “Lease Premiums” for more information on premiums or consideration in the nature of a premium.

³⁷ *CIR v Butcher Bros (Pty) Ltd*, 1945 AD 301, 13 SATC 21 at 33.

the intellectual property or imparting or undertaking to impart such knowledge in relation to the use of such intellectual property.

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.*³⁸ 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”:³⁹

“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 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.”

A composite fee that includes various goods and services to be supplied by the franchisor under the franchise agreement that are not the intellectual property, or imparting or undertaking to impart knowledge related to the use of the intellectual property, as contemplated in section 11(f)(iii) and (iv) respectively, 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 composite fee relate to the intellectual property or knowledge specified in section 11(f)(iii) and (iv) that may qualify for a deduction under section 11(f), an apportionment can be made. The taxpayer will have to substantiate that section 11(f) applies⁴⁰ to the identifiable qualifying component or components of the composite fee.⁴¹

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.⁴²

Example 2 – Taxation and deductibility of initial fees, licence fees and royalty payments

Facts:

X is the owner and franchisor of Fine Dining Restaurant. In January 2020 C entered into a 10-year franchise agreement with X. Under 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 registered intellectual property and knowledge relating to the use of the intellectual property.

³⁸ [2004] 2 All SA 1 (SCA), 66 SATC 131.

³⁹ At 139.

⁴⁰ That is, that all the requirements of the section are met.

⁴¹ 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.

⁴² Section 102(1)(b) of the Tax Administration Act 28 of 2011.

On 1 April 2020, 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 year of assessment covering the period 1 April 2020 to 31 March 2021, C's royalty payments amounted to R210 000.

Result:

a) Franchisor:

The initial fee of R600 000 received by X was of a revenue nature, being income earned in a scheme of profit-making through the productive use of its assets. This amount was included in X's gross income and taxed accordingly.

The royalty payments of R210 000 received from C were likewise included in X's gross income and taxed as such.

b) Franchisee:

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. The expenditure was accordingly incurred with the intention of creating a capital asset (an income-earning structure) in the hands of the franchisee. This initial fee was therefore of a capital nature and not deductible under section 11(a).

The licence fee of R200 000 incurred by C as part of the initial fee was similarly of a capital nature as held in ITC 1726.⁴³ Since C was 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 was not entitled to claim a deduction for the cost of the licence under section 11(gD). However, given that the licence fee was 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 may therefore be deductible under sections 11(f)(iii) and (iv).

The recurrent royalty payments (see 3.4) of R210 000 made by C qualified 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.

(c) Higher royalty payments *in lieu* of upfront payments

If higher monthly fees (usually referred to as royalty payments – see 3.4) are paid *in lieu* of an upfront fee, an apportionment of the royalty between the amount relating to the grant by the franchisor to the franchisee of the right of use of the franchisor's intellectual property and related business processes (the franchisee's income-earning structure) and the ongoing cost of using that right (income-earning structure, see 3.4.2) to earn income will need to be made. In other words, to the extent that the royalty relates to the acquisition by the franchisee of its income-earning structure, it will retain its character as an expense of a capital nature and will not qualify for a deduction under section 11(a).

⁴³ (2000) 64 SATC 236 (G). See 3.3.2(a).

Although the portion of the recurrent royalty payments relating to the acquisition by the franchisee of the right to use the franchisor's intellectual property and business processes are, in these specific circumstances, regarded as being of a capital nature, they cannot be said to be a "premium or consideration in the nature of a premium" as they remain a recurring royalty expense and are not paid in addition to, or in lieu of, any recurrent consideration [see **3.3.2(b)**]. The franchisee would in these specific circumstances therefore 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 –⁴⁴

"...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)

(d) Other

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

3.4 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.⁴⁵ It is a "fee payable in return for the use of intellectual property, be it a musical or literary work, a trademark, a protected name or other processes".⁴⁶ 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 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 following clause is commonly found in franchise agreements:⁴⁷

"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."

⁴⁴ 1946 AD 610, 14 SATC 155 at 170.

⁴⁵ Consistent with the International Franchise Association definition of "royalty" in **2**.

⁴⁶ www.absa.co.za/business/sector-solutions/franchising/beat-the-jargon/ [Accessed 16 August 2021].

⁴⁷ Daniel Erasmus "Royalties (franchise fees) and their deductibility" page 11 available online at www.fasa.co.za/documents/Royalties_DanielErasmus.pdf [Accessed 16 August 2021].

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. As indicated above, in return for the use of the intellectual property, the franchisee makes recurring payments to the franchisor.

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 obtained by the franchisee. Royalty payments are normally calculated as a percentage of the franchisee's turnover but can be a fixed amount and are normally payable weekly, monthly or annually.

3.4.1 Tax implications for franchisors

In *Vacu-Lug (PVT) LTD v COT*⁴⁸ the sub-licensing of *patent processes and trade marks* were compared to the sub-letting of a business lease. It was stated that the question that ultimately needs to be asked is –⁴⁹

“...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 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 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, royalties are derived by the franchisor for the ongoing use of its intellectual property and business processes in a scheme of profit-making. Royalty payments do not generally relate to the 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.

3.4.2 Tax implications for franchisees

In order for royalty payments to be deductible under section 11(a), the expenditure must not be of a capital nature. It must therefore be determined whether the royalty payment can properly be regarded as part of the cost of performing the franchisee's income-producing operations or as part of the cost of establishing, improving or adding to its income-producing structure.⁵⁰ 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.⁵¹

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.

⁴⁸ 1963 (2) SA 694 (SR), 25 SATC 201.

⁴⁹ At 206.

⁵⁰ *New State Areas Ltd v CIR*, 1946 AD 610, 14 SATC 155 at 164.

⁵¹ *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936 CPD 241, 8 SATC 13.

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*.⁵²

The Supreme Court of Appeal in *BP Southern Africa (Pty) Ltd v C: SARS*⁵³ 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 court held that the annual royalty payments were of a revenue nature based on the fact that –⁵⁴

- the purpose of the expenditure was to procure the use – not ownership – of the intellectual property;
- the recurrent cost of procuring the use of something which belongs to another is usually recognised as revenue in nature, the most obvious example being the recurrent rent paid for the use of premises and the annual royalties in the case were indistinguishable from recurrent rent paid for the use of another's property; and
- no new asset for the enduring benefit of the taxpayer was created in consequence of the expenditure.

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;⁵⁵ 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.

⁵² [2007] JOL 19430 (SCA), 69 SATC 79.

⁵³ [2007] JOL 19430 (SCA), 69 SATC 79 at 84.

⁵⁴ [2007] JOL 19430 (SCA), 69 SATC 79 at 84.

⁵⁵ *C: SARS v Kajadas Cosmetics (Pty) Ltd*, 2002 (4) SA 709 (T), 64 SATC 200 at 203 and ITC 1365 (1982) 45 SATC 27 (T). 68 SATC 9 (C). See also **3.3.2(c)**.

Example 3 – Taxability of royalty payments which include other fees

Facts:

X is the owner and franchisor of Fine Dining Restaurant. In January 2020 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 000.⁵⁶ A royalty payment, calculated at 10% of turnover, was also payable. On 1 April 2020 M officially began trading as a restaurateur under the name of X's Fine Dining. For the year of assessment covering the period 1 April 2020 to 31 March 2021, 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

The aggregate amount of R230 000 formed part of X's gross income and was taxable.

b) Franchisee:

The monthly fees of R60 000 (R5 000 x 12) paid to X during the year of assessment *in lieu* of a lump sum initial fee were not deductible under section 11(a) because 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* case⁵⁷ stated 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 could be instances, such as those in this example, in which the recurrent expense (monthly fee) creates an income-earning structure and is therefore of a capital nature. The royalty payments amounting to R170 000 qualified as a deduction under section 11(a).

3.5 Royalties on "tainted intellectual property"

Under section 23I any expenditure incurred for the use or right of use or permission to use "tainted intellectual property"⁵⁸ is not deductible⁵⁹ to the extent the amount of expenditure does not constitute income received by or accrued to any other person or to the extent it does not constitute a proportional amount of net income of a controlled foreign company⁶⁰ which is included in a resident's income under section 9D. The prohibition of the deduction does not, however, apply if the expenditure is deductible under section 11(gC), that is, expenditure incurred in acquiring the intellectual property listed in that section (see 3.2.1) or if it is a deduction allowed in respect of trading stock. In essence, "tainted intellectual property" is

⁵⁶ Calculation of the R5 000: R600 000 / 10 years = R60 000 a year; R60 000 / 12 months = R5 000 per month.

⁵⁷ [2007] JOL 19430 (SCA), 69 SATC 79.

⁵⁸ As defined in section 23I(1).

⁵⁹ Section 23I(2).

⁶⁰ Defined in section 1(1) and section 9D(1). Broadly, a foreign company is a controlled foreign company if more than 50% of its total participation rights are directly or indirectly held, or more than 50% of its voting rights are directly or indirectly exercisable, by one or more persons that are residents other than persons that are headquarter companies. A foreign company is also a controlled foreign company if its financial results are reflected in the consolidated financial statements, as contemplated in IFRS 10, of any company that is a resident, other than a headquarter company.

specified “intellectual property”⁶¹ that is or was the property of a resident taxpayer, or in certain circumstances a “connected person”⁶² 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 taxpayers in South Africa, thus reducing the South African tax base. In the absence of section 23I, this could be achieved by royalties being deductible in the hands of the resident licensee (franchisor or franchisee) but not being taxable, or taxable at a low rate of tax, in the hands of the licensor (a foreign franchisor). Section 23I applies to expenditure incurred on or after 1 January 2009.

In the context of a franchise arrangement, section 23I may therefore apply if, for example, a resident franchisor or franchisee (or a connected person in relation to the franchisor or franchisee) develops specified intellectual property and sells 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) and the amount derived is also not included in a resident’s income through the attribution of net income of a controlled foreign company under section 9D. If applicable, 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.

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 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 South African withholding tax on royalties at 15%.

Importantly, in order for the allowable portion of the royalty to be permitted under section 23I(3), South African withholding tax on royalties must be “payable” at the prescribed rates. It follows that if South Africa is prohibited from imposing the withholding tax on royalties under the applicable tax treaty, if the rate of withholding tax on royalties of 15%⁶³ is reduced below the prescribed rates under an applicable tax treaty or if an exemption applies,⁶⁴ 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.

Broadly, section 23I(4) provides that the prohibition of the deduction under section 23I(2) does not apply if the aggregate amount of taxes on income payable to foreign governments by a controlled foreign company contemplated in section 23I(2) is at least 67,5% of the normal tax that would have been payable on that amount had the controlled foreign company been a resident.⁶⁵

⁶¹ Section 23I(1).

⁶² See Interpretation Note 67 “Connected Persons”.

⁶³ Section 49B.

⁶⁴ Section 49D.

⁶⁵ See section 23I(4) for detail.

Example 4 – Royalties paid to a foreign entity for “tainted intellectual property”

Facts:

Franchisor X, a South African resident, is the developer of intellectual property specified in section 23I. In 2020 X sold the intellectual property to a foreign entity, Z.

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 regular royalty payments. X and Y are not connected persons. Income from granting the use or right of use of all intellectual property constitutes 40% of X's income.

In terms of a tax treaty entered into between South Africa and Z's country of residence, the royalties are not taxable in South Africa.

None of Z's income is included in a resident's income through attribution under section 9D.

Result:

(See section 23I(1) for the definitions of end user, intellectual property, tainted intellectual property and taxable person. Draft Interpretation Note “Prohibition of Deductions for Certain Intellectual Property” provides further guidance on these definitions.)

Royalties payable by Y to X

The royalties payable by Y to X were included in X's gross income and taxable as such.

Section 23I(2) does not prohibit the deduction claimed by Y under section 11(a) for the royalty expenditure incurred as the royalties paid by Y were not for the use of “tainted intellectual property” and the full amount of the expenditure constitutes income for Z. The intellectual property licensed by X to Y is not “tainted intellectual property” as:

- although Y is an “end user”, since Y is a taxable person using the intellectual property to derive income other than mainly by granting the right of use of the patent to another person;
- the intellectual property was never the property of Y or a taxable person that is or was a connected person in relation to Y, or the property of X (taxable person) at the time Y uses the intellectual property and incurs the royalty expense.

Royalties payable by X to Z

The intellectual property is “tainted intellectual property” as:

- X is an “end user”, since X is a taxable person using the patent to derive income other than from mainly (mainly meaning more than 50%) granting the right of use of the patent to another person (only 40% of X's income is derived by virtue of the granting of the right of use of intellectual property); and
- the intellectual property was previously X's property.

As such, X is denied a deduction of the full royalty expense under section 11(a) by section 23l(2), since the royalty does not constitute income for Z. The royalty is deemed to have been derived from a source in South Africa,⁶⁶ however it is not income since Z is the beneficial owner of the intellectual property and the applicable tax treaty gives Country A exclusive taxing rights.

Section 23l(a) and (b) do not permit a partial deduction because South Africa is prohibited from imposing any royalty withholding tax under the applicable tax treaty. Accordingly, the full amount of royalties paid by X to Z was denied a deduction under section 23l(2).

Example 5 – Royalties paid to a foreign entity for “tainted intellectual property”

Facts:

S and JPT have concluded a franchise agreement as franchisor and franchisee respectively. S and JPT are residents and connected persons.

S developed an invention and sold it to B, a resident of Country X. B filed a patent application in South Africa for this invention and licensed the patent to JPT for an annual licence fee of R600 000.

No tax treaty exists between South Africa and Country X. None of B’s income is included in a resident’s income through attribution under section 9D.

Result:

(See section 23l(1) for the definitions of end user, intellectual property, tainted intellectual property and taxable person. Draft Interpretation Note “Prohibition of Deductions for Certain Intellectual Property” provides further guidance on these definitions.)

The licenced patent is “tainted intellectual property” as:

- JPT is an “end user”, since JPT is a taxable person using the patent to derive income other than from mainly granting the right of use of the patent to another person; and
- the patent was previously the property of a taxable person (S) that is a connected person to JPT.

Therefore, section 23l(2) denies JPT a deduction for the annual licence fee to the extent the licence fee does not constitute income (essentially gross income less exempt income) received by or accrued to another person. The annual licence fee does not constitute income for B because even though it is deemed to have been derived from a source in South Africa⁶⁷ and thus constituted South African gross income, the annual licence fee received by B is exempt from tax under section 10(1)(l).⁶⁸

⁶⁶ Section 9(2)(d), read with the definition of “intellectual property” in section 9(1).

⁶⁷ Section 9(2)(d), read with the definition of “intellectual property” in section 9(1).

⁶⁸ Section 10(1)(l)(i) exempts an amount of royalty as defined in section 49A unless, in the case of a natural person, that person was present in South Africa for more than 183 days in aggregate during the 12 months preceding the date that the royalty was received or accrued. Section 10(1)(l)(ii) further excludes from the exemption any royalty paid which was effectively connected with a permanent establishment of the payer in South Africa.

As such, in the first instance JPT is denied a deduction of the full annual licence fee under section 23I(2). However, since 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 3.6), JPT was entitled to claim a deduction of R300 000 ($\frac{1}{2} \times R600\ 000$ expenditure incurred) under section 23I(3)(b). If there had been an applicable tax treaty between South Africa and Country X which reduced the withholding tax rate to 10%, JPT would have been entitled to a deduction of one-third of the licence fee, namely R200 000 ($\frac{1}{3}$ of R600 000) under section 23I(3)(a).

3.6 Withholding tax on royalties

Broadly speaking, withholding tax on royalties applies to royalties from a source within South Africa paid by any person (whether a resident or not) to or for the benefit of a non-resident for the use of certain intellectual property belonging to that person or for the imparting of or the undertaking to impart any scientific, technical, industrial or commercial knowledge or information, or the rendering of or the undertaking to render any assistance or service in connection with the application or utilisation of such knowledge or information. The Act contains certain exemptions from withholding tax on royalties. Withholding tax on royalties is currently levied at a rate of 15%, however, that rate can potentially be reduced or eliminated by an applicable tax treaty.

The withholding tax on royalties system imposes liabilities on both the payer of the royalty and the foreign person that receives it or for whose benefit it is paid. Generally, the payer is required to withhold the withholding tax on royalties from the royalty payment and to pay it to SARS by the last day of the month following the month in which the royalty was paid and the foreign person is liable for the tax unless it has actually been paid over to SARS by someone else (often the payer of the royalty). "Paid" is defined as the earlier of paid or due and payable.

See Interpretation Note 116 "Withholding tax on royalties" for guidance on the interpretation and application of sections 49A to 49H which relate to withholding tax on royalties.

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 often 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 cancellation 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. In these circumstances, the early cancellation payment made by the franchisor to the existing franchisee would generally 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 to be in existence. This expenditure 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.

If 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.⁶⁹ Consequently, the payment will represent expenditure of a capital nature and will not qualify as a deductible expense under section 11(a).

In determining whether the compensation received by a franchisee from a franchisor for the early cancellation of the agreement is of a revenue nature and must be included in gross income or is of a capital nature and possibly subject to capital gains tax, it is necessary to determine 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).

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.⁷⁰

In ITC 1279⁷¹ Coetzee J quoted with approval the following dictum in the English case of *IRC v Fleming & Co (Machinery) Ltd*:⁷²

"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."

Coetzee J held that this is a crisp and logical approach to the problem.

The principles that emerge from the various cases dealing with compensation amounts was aptly summarised by Melamet J in ITC 1557⁷³ 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

⁶⁹ *Seeff Properties CC v CIR* (1993) 60 SATC 407 (CPD) at 411.

⁷⁰ *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.

⁷¹ (1977) 40 SATC 254 (T) at 258.

⁷² (1951) 33 TC 57.

⁷³ (1992) 55 SATC 218 (T) at 226.

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.”

In *WJ Fourie Beleggings v C: SARS*⁷⁴ the SCA held that it is not possible to devise a definitive or all-embracing test to determine whether a receipt or accrual is of a capital nature. Further, that there is a fundamental distinction between a contract which is a means of producing income and a contract directed by its performance towards making a profit.⁷⁵

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.⁷⁶

The rationale for this conclusion is that –⁷⁷

“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”.

The above principles were again confirmed in the Supreme Court of Appeal decision in *Stellenbosch Farmers’ Winery v C: SARS*⁷⁸ 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 cancellation of the franchise agreement, the payment 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 cancellation.

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

Similar to the position above, a franchisee may prematurely terminate a franchise agreement for any number of reasons. The franchisee would generally be required to pay compensation to the franchisor. The franchisee will be entitled to a deduction of the expense under section 11(a) only if the franchisee is able to show that the expense was incurred in the production of its income, that is, that the expenditure was so closely connected with the business operations performed for purposes of earning income that it is proper to regard the expense as part of the cost of performing those operations.⁷⁹ The expense must also not be of a capital nature.

⁷⁴ 2009 (5) SA 238 (SCA), 71 SATC 125.

⁷⁵ At 131.

⁷⁶ ITC 1341 (1980) 43 SATC 215 (T); *Taeuber and Corssen (Pty) Ltd v SIR*, 1975 (3) SA 649 (A), 37 SATC 129 and *Stellenbosch Farmers’ Winery v C: SARS* 2012 (5) SA 363 (SCA), 74 SATC 235.

⁷⁷ Per McEwan J in ITC 1341 (1980) 43 SATC 215 (T) at 224.

⁷⁸ 2012 (5) SA 363 (SCA), 74 SATC 235.

⁷⁹ *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.

Generally, the compensation paid by the franchisee to the franchisor for the early cancellation of the agreement 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 be properly classified as not being in the production of income, 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.

The capital costs incurred in acquiring the right of use of the franchisor's intellectual property and business processes (see 3.2.2 and 3.3) must also be taken into consideration upon the termination of the franchise. Upon termination, these costs will form part of the base cost of the asset disposed of by the franchisee for CGT purposes.

The principles discussed in 3.7.1 will apply equally when a franchisor receives a sum of money from a franchisee owing to the early cancellation 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 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 the cessation of a significant part of the franchisor's income-earning structure, the money will be of a capital nature.⁸⁰

For example, should a franchisor receive compensation from a franchisee for the early cancellation of a franchise agreement, and the franchisor is 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 since it effectively remains in existence. The payment instead relates to the franchisor's income-earning operations.

Each cancellation should, however, be evaluated on its own merits before deciding on the tax treatment of any compensation.

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 pay a penalty to the franchisor. In such event, the expense must be evaluated in light of the requirements of section 11(a) 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.

The penalty received by or accrued to the franchisor 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 and no single solution applies.

⁸⁰ *Stellenbosch Farmers' Winery v C: SARS 2012 (5) SA 363 (SCA), 74 SATC 235.*

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 **3.3** 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 cover 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 generally, 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 being of a revenue nature would accordingly constitute gross income for the franchisor. As in the case above, the franchisor will generally be entitled to a tax deduction, either under section 11(a) or as a capital allowance, for any expenditure incurred 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 incurred 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.

If the expenditure was made with a view of bringing into existence an asset or an advantage for the enduring benefit of the franchisee's trade, 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 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 with the aim of familiarising 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 in providing the requisite training provided it is of a revenue nature.

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 the franchisee's revenue. The fact that a franchisee trades more effectively does not convert the expenditure into a capital expense.⁸¹

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).

Under section 11A, training fees incurred before the commencement of trade will be allowable only when trade commences. However, such deduction will be granted only if the training fees would have been allowed under section 11(a) had the fees been incurred after the commencement of trade. The deduction is also ring-fenced against the income from that particular trade.⁸²

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.⁸³ A capital gain arises when the "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 including rights to variable or fixed payments as consideration for the working of, or the right to work mineral deposits, sources and other natural resources; and
- Any asset which is effectively connected with a permanent establishment of the non-resident in South Africa.

⁸¹ *Mobile Telephone Networks Holdings (Pty) Ltd v C: SARS*, (2011) 73 SATC 315 (SG) at 324.

⁸² See Interpretation Note 51 "Pre-trade Expenses and Losses".

⁸³ Eighth Schedule.

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; 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 taxable only in Mauritius.

The sale of the franchisee’s interest in the legal entity that carries on the franchise business will potentially be subject to CGT, since it constitutes the disposal of an asset. The franchisee’s interest can, for example, consist of shares in the company that carries on the franchise business. The “proceeds” derived by the franchisee on disposal of its interest in the entity and the “base cost” of such interest have to be determined. For an asset acquired on or after 1 October 2001, this base cost is generally determined under paragraph 20 of the Eighth Schedule which includes the cost of acquiring or creating the asset.

Apart from the sale of the franchisee’s interest in the entity, the sale of a licence by the franchisor may 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.⁸⁴

⁸⁴ See the *Comprehensive Guide to Capital Gains Tax* for further information. For more information on small businesses, see the *Tax Guide for Small Businesses*.

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 defined⁸⁵ 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* 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 that, amongst other requirements, 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.⁸⁶

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.

⁸⁵ Paragraph 57(1) of the Eighth Schedule.

⁸⁶ For more information on restraint of trade payments, see Interpretation Note 7 “Restraint of trade payments”.