

Royalties (franchise fees) and their deductibility



PRESENTED BY DANIEL ERASMUS

TAX talk

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Introduction

By way of introduction, the statistics applicable to franchise operations in South Africa are as follows:

- 391 franchises;
- 22 825 outlets;
- 284 447 jobs (0.5% of the population);
- Total turnover per annum R 129,2bn (10.7% of GDP);
- Average annual growth in the franchise industry - 20.4%.

(source: www.succeed.co.za March 2006, pgs 95 to 101)

Most Franchise operations give rise to the following relationships between franchisor and franchisee:

- operate a branch office;
- operate a wholly owned subsidiary;
- operate a joint venture; or
- licence a master franchising agreement with a local partner.

The total annual turnover of ongoing franchise fees payable to franchisors (at an estimated 5% of turnover) is in the region of R 6,46bn per annum. Going back 5 years

(and adjusting the sum by 20% per annum), the total franchise fees payable by franchisees to franchisors would be in the region of R 21.71bn (on average, for the whole industry). If SARS start aggressively pursuing the principles in the ITC 11454 judgment (discussed below and at the FASA tax seminar) against all franchisees on their franchise fee payments to franchisors, assuming they go back 5 years to add back these deductions (based on a tax rate of 30% on average), the franchise industry will suffer the following losses:

- R 6,51bn in back taxes to be repaid to SARS (R 275 000 per franchisee);
- R 13,02bn in 200% penalties (R 550 000 per franchisee);
- R 8,18bn in tax interest (R 360 000 per franchisee);
- An estimated total of arrear **tax of R 1,185m per franchisee.**

(calculations based on the above statistics, estimates and averaging for illustrative purposes only)

There will be great incentive for SARS to pursue the course of action set out above, and as a result, there is very good reason for the franchise industry to be prepared for this.

What preparation is necessary?

SARS will probably first approach franchisors requesting information in terms of section 74A of the Income Tax Act, 1962. They will want to know the details of all the franchisees of the franchisor. In this regard the provisions of section 74A must be carefully considered:

- For what administrative purposes is the information required?
- In respect of which specified taxpayers?

SARS are not allowed to extract information from taxpayers unless they can show that there is a set of facts that matches one of the subsections of the definition of "for the purposes of the administration of this Act". If they can't do this, they are simply not entitled to the information.

In addition to the above, they can only request information in respect of taxpayers as defined in the Income Tax Act. This means they cannot ask for lists of names unless they can specify whether or not they are taxpayers. This means that SARS can only request information in respect of specified and named taxpayers. If SARS merely asks for a list of names of franchisees this would not strictly fall into the provisions of section 74A of the Income Tax Act.

Assuming SARS are ultimately successful in specifying which taxpayers they would like information on, the Franchise industry preparation for a SARS investigation should also entail being able to answer the following questions in detail, after seeking the appropriate legal advice:

- What do the contracts say?
- What was and is the true intention of the parties?
- Are there any tax opinions to back up the contracts?
- Can the contracts be amended to reflect the true intention of the parties?
- What is the split between the initial fees and the monthly/annual payments?
- How was this calculated, and why was there a split?
- Have the various element attached to “the rights” been properly described?
- Have the provisions of section 11(f) or 11(gA) ever been applied, and are they relevant to the facts at hand?
- What are the amounts of franchise fees paid over the past years?
- How has this been disclosed in the financials and the tax returns?
- Can SARS ever say that there has been non-disclosure or inaccurate disclosure?
- Can it be said that part of the franchise fees payable can be allocated to the acquisition of the right to the exclusive use area and the intellectual property?
- Other questions will arise in consultation.

Once SARS has concluded their investigation into royalty or similar payments, the taxpayer is entitled to request a letter of findings before SARS issues an assessment. In response to this letter of findings the taxpayer is well advised (based on a careful analysis of all the information above) to give reasons why SARS intentions to disallow

royalty payments is incorrect. This should take the form of a fully motivated oral and written presentation aimed at convincing SARS that they are wrong.

The important aspect of this presentation lies in the fact that SARS cannot just raise additional assessments now. Any decision they now take to raise additional assessments must take into careful consideration the presentation made by the taxpayer. If SARS have ignored new facts or arguments raised by the taxpayer, then this may entitle the taxpayer to have the additional assessments set aside in the High Court.

The above procedures are not set out in any of the legislation on tax, but is accepted practice within SARS. In this regard a legitimate expectation has been created in favour of taxpayers.

The franchisor and franchisee contractual relationship

The “rights” arrangements between franchisor and franchisee will usually be along the following broad lines:

The franchisee will pay an initial start-up fee to acquire “the rights” to operate the franchise in a particular area (a lump sum), followed by an annual or monthly fee to maintain that right, based on turnover, whereas others may be fixed.

There will be variations of this theme, all of which are important to consider so as to establish what the tax implications are.

Some may be structured in such a way that there is no initial start-up fee, but a higher annual or monthly fee.

Then there is the question of what is meant by “the rights”. These will usually include the exclusive right to operate in a particular area the business together with the use of

the intellectual property. "The rights" are a bundle of rights made up of the following components:

- An exclusive use area to conduct the business in;
- The right to use the intellectual property, including trade marks, trade name, patents, copyrights, designs, permitted name, software, and know-how.

The acquisition fee, insofar as it is allocated to "the rights" is often specified as a lump sum, without expressing what portion is allocated to the exclusive use area (similar to a restraint payment), and what portion is allocated to the initial fee for the right to use the intellectual property.

The reason for not splitting the portions is usually to ensure that the franchisor gets a lump sum which is ostensibly of a capital nature. But then this in itself is a bit of a ruse, as it is now trading in disposing of intellectual property rights, where the consideration obtained will always be of a revenue nature. Unfortunately, doing this does not benefit the franchisee as SARS will seek to disallow the initial start-up fee in total (which is probably what has happened to date anyway – but not necessarily right!).

So in summary:

- There is an initial start-up fee payable for the **exclusive use area**;
- There is an initial start-up fee payable to acquire the **right of use of the intellectual property** such as trade marks, trade name, patents, copyrights, designs, permitted name, software, and know-how, as opposed to just for the actual use of the intellectual property;
- There are ongoing **fees payable to maintain** the use of the exclusive use area and the use of the intellectual property (such as franchise fees or royalties).

The **exclusive use area** fee is arguably an expense of a capital nature. It is made to create an income-producing business. The initial fee paid for the exclusive use area will probably not qualify for deduction under section 11(f), discussed below.

The initial fee paid for the **right of use of the intellectual property** (if clearly specified as such in the agreements and separately identifiable) is also arguably an expense of a capital nature, as it is made to create an income producing business.

However, section 11(f) of the Income Tax Act, 1962 is then available to the franchisee to claim a deduction. This provision states as follows:

“(f) an allowance in respect of any premium or consideration in the nature of a premium paid by a taxpayer for ... (iii) the right of use of any patent as defined in the Patents Act, 1978 (Act No. 57 of 1978), or any design as defined in the Designs Act, 1993 (Act No. 195 of 1993), or any trade mark as defined in the Trade Marks Act, 1993 (Act No. 194 of 1993), or any copyright as defined in the Copyright Act, 1978 (Act No. 98 of 1978), or 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 film, sound recording, advertising matter, patent, design, trade mark, copyright or other property as aforesaid...”.

The provision finishes off which various limitations to the allowances. However, professional advice should be sought before attempting to apply any of these provisions, to ensure that the facts of your case fall squarely within these provisions.

The ongoing **fees payable to maintain** the use of the exclusive use area and the use of the intellectual property (such as franchise fees or royalties) is the expense which is now the subject of uncertainty in light of the recent unreported tax case ITC 11454

which SARS won against a taxpayer who attempted to deduct royalty payments to the grantor of the rights situated in the UK.

Until now, royalty payments, have for the most part, been held to be deductible if paid for the use of the rights. This is seen as an expense which forms part of the day to day running expenses of a taxpayer, closely connected to its trade, and therefore of a revenue expense. A bit like the rental paid for your premises.

However, the court in **ITC 11454** did not believe the comparison between rentals and royalties is a good one, as the payment of a royalty for the intellectual property use gives structure and goodwill, essential for the business's operations. The court went on to find that that the royalty expenditure was akin to expenditure incurred in setting up a business (like franchise fees) and was therefore capital in nature. The court held that the right of use was a valuable asset.

The judgment has been widely criticised by tax specialists as being incorrect. It is also believed that the judgment is going on appeal (we all hope). This will unfortunately not deter SARS pursuing the disallowance of expenditure similar to royalty payments (such as franchise fees), until the matter is finally settled in the highest court. As one commentator put it "all that is achieved is legal uncertainty, which in turns breeds inequity."

In the past, royalty payments were disallowed as deductions due to a variety of errors made by the taxpayers in their tax planning. For instance:

In **ITC No 1365**, 45 SATC 27, 1988 , B had been granted a mining lease in to dig for diamonds. In 1978 B ceded the lease to the taxpayer in consideration of, inter alia, "a royalty of 20% of the producer's value or selling price, whichever is the greater of the gross precious stones won from the said land".

In its return of income the taxpayer sought to deduct the amount it paid in "royalties", but this was disallowed by the Commissioner on the ground that the payments were of a

capital nature. In the tax court the appeal was dismissed, on the basis that the payments were in respect of the **acquisition of the right to mine** by stepping into the shoes of B and not a payment to B similar to a rental and were accordingly of a capital nature.

The position of the taxpayer in the case is analogous to the case where an income producing asset is acquired in return for, say, an annuity or other recurring payment. **The expenditure is directed towards the acquisition of the capital asset** and there is no difference in the nature of the expenditure whether it is paid in one lump sum or in instalments or in the form of a recurring payment which may be taxable as income in the hands of the recipient.

In Commonwealth **Aluminium Corporation Ltd v FCT** (1977) 7 ATR 376 (Supreme Court of Victoria), the taxpayer had claimed the deduction of royalties on bauxite mined by it. The Federal Commissioner of Taxation rejected the claim because of supposed uncertainties and steps that had to be taken before finality was reached about the royalty payments.

Newton J pointed out that expenditure can be incurred even if the quantum of the liability cannot be precisely ascertained, provided that it is capable of reasonable estimation.

Here the deductibility of the royalties did not turn on whether they were of a capital nature or not, but on the determination of the quantum. It was accepted that the royalties were of a revenue nature.

In **ITC No 1316**, SATC 229, 1984, Squires J made a distinction between **fees paid for the filing and registration of a patent (expenditure of a capital nature)**, and fees paid for the renewal of the patent (expenditure of a revenue nature). The first is for the creation of an income-producing asset, the other is one incurred as part of the normal day to day income producing expenses and activities to **maintain the original**

patent obtained. The taxpayer had not discharged the onus of proof that he fell into the latter, due to conflicting facts that existed.

This is similar to a franchisee paying an initial fee to acquire the franchise rights in a particular area. This would be part of the cost of establishing the income-producing activities. Whereas a monthly or annual franchise fee paid to renew and maintain those initially obtained rights would be part of the costs associated with the normal day to day income producing activities.

In **CIR v Kajadas Cosmetics (Pty) Ltd** 2002 (4) SA 709 (T) the court found that an annual fee paid to a franchisor in return for the exclusive distribution rights was of a capital nature being expenditure related to creating the income earning machine (the exclusive right to distribute the product, as opposed to the right to use intellectual property).

In **Rand Mines (Mining Services) Ltd v CIR** 59 SATC 85 the court held that a payment made to secure a management contract was expenditure of a capital nature, similar to payments made in respect of franchise agreements.

By contrast, in **ITC 1726**, 64 SATC 236, it was found that an ongoing fee paid by the licensee of a non-exclusive cellular telephone service, was recurrent expenditure upon which the continued existence of the licence was dependant, and hence of a revenue nature. In that case, the taxpayer had also paid R100 million upfront for the right to conduct the service for a renewable period of 15 years (this payment was found to be of a capital nature).

Furthermore, in **CSARS v SA Silicone Products (Pty) Ltd** 66 SATC 131 (SCA), the SCA held that a trademark licence is not similar in nature to a trademark. The licence is not intellectual property. It is merely the grant of a temporary right of use, conferring no monopoly or the protection in law with it, the absence of a power to dispose of its value, and the inability to restrict the use of the licence intellectual property.

Then there is the new **unreported case of ITC 11454**. For an explanation and criticism of this judgement I refer to two articles written by two tax colleagues in the magazines Without Prejudice (January 2006 edition) and De Rebus (February 2006 edition)

The test in determining whether expenditure is of a capital or revenue nature is to determine whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant or machinery (**New State Areas LTD v Commissioner for Inland Revenue** (14 SATC 155)).

In terms of the typical franchise agreements it is evident that what the taxpayer has acquired is the right of use from time to time of intellectual property. This right that is acquired should be regarded as part of the cost of performing the taxpayer's income earning activities and is accordingly of a revenue nature.

This statement is evidenced by the following typical clauses in the relevant agreements:

"Subject to the terms and conditions in this agreement, the Licensor hereby grants to the Licensee for the Term of this 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 Licensee (which licence is revocable under circumstances set out in this agreement)..."

"The Trade Marks are and will remain the sole and exclusive property of the Licensor."

It is clear from these clauses that no proprietary rights were acquired; only a right of use was acquired. The royalty therefore constitutes a payment for the right of use.

Hence, the royalty payments constitute a cost that should be regarded as part of the cost of performing the income-earning operations of the taxpayer and are therefore not of a capital nature.

SARS' Practice prevailing at the time of the assessment

The first proviso to s 79(1) limits the authority of the Commissioner to reopen an assessment and raise an additional assessment in terms of paragraph (iii) of the proviso, in that the Commissioner may not raise an additional assessment if the amount that should have been assessed to tax under an assessment was, in accordance with the practice generally prevailing at the date of the assessment, not assessed to tax.

The interpretation to be given to the wording the 'practice generally prevailing at the time' is the practice known to and applied by the Commissioner's office through the Law Application Branch at the Commissioner's office (SARS Practice Manual Page A 584 (1)).¹

In **CIR v SA Mutual Unit Trust Management Co Ltd** it was held the word 'practice' in this context means 'a habitual way or mode of acting' .

In **ITC 1459** at 148 Howie J said:

"As to the words 'practice generally prevailing' I consider that these words mean a practice which is both known to the Commissioner and which he has authorised for application by the various Receivers of Revenue throughout the country."

In **C:SARS v Hulett Aluminium (Pty) Ltd** it was held that a practice generally prevailing is one which is applied generally in the different offices of the department.

If SARS raises an additional assessment on this point, the onus will be on the taxpayer to show, on a preponderance of probability, that the original assessment was issued in accordance with a practice generally prevailing at the time of the assessment of the original assessment.

¹ See also CIR v SA Mutual Unit Trust Management Co Ltd 1990 (4) SA 529 (A) (52 SATC 205 at 215); ITC 1459 (51 SATC 142 at 148); ITC 1495 (53 SATC 216 at 225); C:SARS v Hulett Aluminium (Pty) Ltd 2000 (4) SA 790 (SCA) (62 SATC 483).

Section 23 of the Constitution read with the Promotion of Access to Information, 2000, provides that every person shall have the right to access to all information held by the State or any of its organs at any level of government in so far as such information is required for the exercise or protection of any of his or her rights. Should the taxpayer finds itself in the position that it must show on a balance of probabilities that the practice prevailing at the time was to allow a deduction for royalties, it may subpoena the relevant senior SARS official from its Head Office in Pretoria to attest to the practice followed by SARS during the years of assessment in question.

On a further positive note, SARS have created a legitimate expectation in their practice manual published by Butterworths by stating the following:

"2. Premiums or royalties paid for the right of use of a patent or trademark are similarly deductible...[page A568(23)]."

This was also confirmed to be the case by a senior and long standing lawyer employed by SARS.

A typical franchise agreement

The following clauses are extracts from a typical franchise agreement taken from a commercially available precedent:

- 1.1** "Advertising Contribution": per cent (.....%) of the gross turnover of the franchised business;
- 1.6** "Continuing Fees": franchise fees of per cent (.....%) of the gross turnover of the franchised business;
- 1.9** "Franchised Business": commencing and undertaking a business of (*give details*) (*at the premises*) (*within the Territory*) in accordance with the business method and using the intellectual property;
- 1.15** "Intellectual Property": all or any of the following: trade marks, trade name, patents, copyrights, designs, permitted name, software, and know-how;
- 1.17** "Minimum Fee": a minimum payment to be set against the continuing fees of R..... (.....RAND);

2 Grant

2.1 In consideration of the payment of the initial fee (*or* the minimum fee) (*and* the insurance premium) (*and* the advertising contribution) and the continuing fees by the Franchisee to the Franchisor on the (*insert date*) and of the subject to the agreements on the part of the Franchisee in this agreement the Franchisor grants to the Franchisee the right to carry on the franchised business in accordance with the operating manual and subject to the terms and conditions of this agreement.

After carefully considering the case law set out above, and in particular ITC 11454, this typical wording may end up causing problems for the franchisee.

The initial fee should specify precisely what it is for: the exclusive use area, the licence, the right of use to the intellectual property, and maybe even the first use of intellectual property, particularly know how and software. These latter items are tax deductible under sections 11(a) and (e) of the Income Tax Act. The right of use of intellectual property is deductible under section 11(f).

The continuing fee should be specifically paid for maintaining the licence and the use of the intellectual property, allocating the relevant portions to the various definable portions of intellectual property (trade marks, trade name, patents, copyrights, designs, permitted name, software, and know-how).

These guidelines should assist in narrowing down the portion that SARS can claim is not tax deductible.

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