KPMG

The Franchise Industry

A more complicated tax landscape than perceived at first glance

October 2016

KPMG.co.za

Contents

1 Introduction

The South African franchise industry is growing. Newspaper headlines and social media feeds abound with news of iconic international brands opening their doors on South African shores. This growth is apparent not only from the arrival of international coffee houses, burger chains and retail stores, but is also reflected in the expansion of many popular South African chains offshore.

Beyond the headlines and expectant tweets, the industry growth is reflected in the 2014 Survey by the Franchise Association of South Africa ('FASA')[1] which reflects that there are over 31 050 franchise outlets in South Africa, 26 percent of which are owned by previously disadvantaged individuals, employing 323 519 people nationally. The impressive growth of the franchise industry is in direct contrast to the exceedingly low South African Gross Domestic Product ('GDP') growth rate of 0.6 percent for the first quarter of 2016 (forecasted to drop to 0.5 percent in the second quarter)[2].

Against this backdrop, the South African Revenue Service ('SARS') has issued a Draft Guide on the Taxation of Franchisors and Franchisees (the 'Draft Guide'). The Draft Guide was released on 7 January 2016 and closed for comment on 12 February 2016. The Draft Guide summarises the typical payments made between franchisees and franchisors under a standard franchise agreement and sets out the tax implications attendant upon those payments for franchisors and franchisees alike. Whist comprehensive in respect of the payments it covers, the Draft Guide is limited in that it only considers the income tax consequences of franchise arrangements for resident franchisors and franchisees. Indirect taxes and international tax considerations are regrettably not considered, notwithstanding that these are pertinent issues for an industry where cash flow is of paramount importance and where cross-border transactions are becoming ever more common. The Draft Guide is further limited in that many of the practical challenges that face the industry are not considered, particularly those challenges faced by franchisees.

Note:

[1] Sponsored by Sanlam

[2] http://www.tradingeconomics.com/south-africa/gdp [Accessed 23 May 2016]

The tax principles as set out in the draft guide are generally well-established and undisputed

2 Summary of the Draft Guide

A summary of the payments covered as well as the recommended treatment set out in the Draft Guide are summarised below:

2.1 **Payments for the creation, acquisition or use of intellectual property by franchisors** are seen as capital in nature. Deductions or allowances may be available under section 11(gB), section 11(gC) and section 11(gD) of the Income Tax Act No. 58 of 1962 ('Income Tax Act'), depending on the nature of the intellectual property in question**.**

2.2 **License fees for obtaining the right of use of the franchisor's intellectual property** (whether included as part of the initial franchise fee or paid on a monthly basis in addition to royalty payments) are capital in nature for the franchisee and therefore not tax deductible. On the other hand, amounts received by franchisors are to be included in gross income, with the costs incurred in drafting franchise agreements being tax deductible.

2.3 **Initial franchise fees payable for obtaining the right of use of the franchisor's intellectual property and business processes are capital in nature** and therefore not tax deductible by the franchisee regardless of whether the amount is payable as an upfront fee or spread over the term of the agreement and paid as a monthly fee. Again, the amounts received by franchisors are to be included in gross income, with the costs incurred in drafting franchise agreements being tax deductible. Fees to renew or extend a franchise agreement are treated in the same manner.

2.4 **Royalty payments for the ongoing use of the franchisor's intellectual property and business processes** will, in most instances, be deductible for franchisees and included in the franchisor's gross income (in contrast amounts paid by franchisees for the acquisition of the right of use intellectual property will be capital in nature and not deductible).

2.5 **Compensation paid by a franchisor for early termination of a franchise agreement** in order to replace the franchisee with a more competent franchisee would, in most instances, be regarded as a receipt of a capital nature for the franchisee.[3] The payment in the hands of the franchisor would be regarded as tax deductible. The tax treatment for the franchisor would, however, differ where the compensation payment was to incorporate the franchisee's operations into its own operations. In this instance, the payment would be regarded as a non-deductible capital expense.

2.6 **Compensation paid by a franchisee for early termination of a franchise agreement would in most instances be regarded as a non-deductible capital expense for the franchisee.** The tax consequences for the franchisor will be dependent on whether the payment is intended to compensate the franchisor for loss of royalties (the amount would be included in gross income) or to compensate the franchisor for the loss of an asset (the amount would be capital in nature)**.**

2.7 **Penalties for breach of contract paid by franchisees would be deductible for the franchisee** provided the requirements of the general

[3] The capital gains tax consequences arising from the disposal of the franchisee's rights under the franchise agreement would also need to be considered.

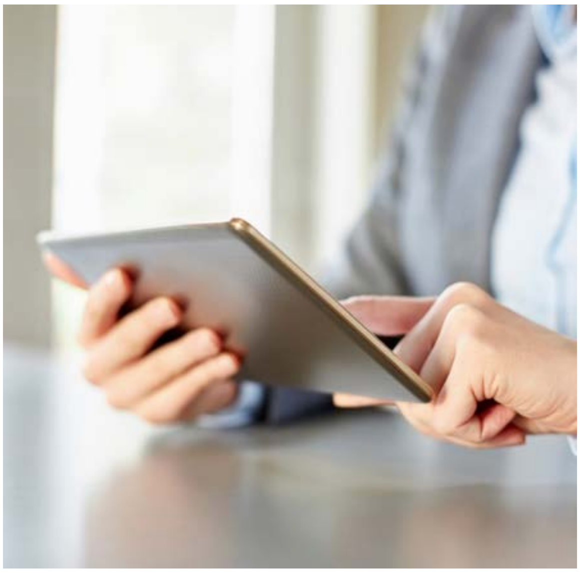
deduction formula as contained in section 11(a) read with section 23(g) of the Income Tax Act are met. For the franchisor, the amount received will generally be of a revenue nature and included in gross income**.**

2.8 **Advertising expenses and training fees would generally be seen to be tax deductible for franchisees** with the amount being taxable in the hands of the franchisors. Franchisors would be entitled to deduct amounts expended on training and promotional activities.

2.9 **Restraint of trade payments will generally be of a capital nature for a franchisee.** Payments received by a natural person would, however, be included in gross income if it relates to the person's past, present or future employment or holding of an office. A franchisor would not be permitted to deduct the payment made, unless the payment is made to a natural person and that payment is or will be included in that person's income. Further, any deduction which is allowed will be spread over the lesser of three years or the period over which the restraint applies.

The above tax principles as set out in the Draft Guide are generally well-established and undisputed. However, in practice, often payments under franchise agreements are composite payments which are not broken down into the categories designated in the Draft Guide.

Very often different terminology to that referred to above is used by industry stakeholders. This, coupled with the generic nature of the analysis within the guide, has raised concerns from industry stakeholders that the tax implications as summarised in the Draft Guide are in reality far more complex than presented



3 Practical complexities not considered with the Draft Guide

The payment of a ‘premium or like consideration

As noted above, initial franchise fees payable for obtaining the right of use of the franchisor’s intellectual property and business processes are capital in nature and therefore not tax deductible for a franchisee, irrespective of whether the amount is payable upfront, on commencement of the franchise agreement, or spread over the term of the agreement and paid monthly. The receipt will constitute income in the hands of the franchisor.

An initial franchise fee can relate to a myriad of different items and/or services performed by franchisors in relation to the specific franchise operation, e.g. territory analyses, specialist equipment, training, site identification etc. However, generally these fees grant the franchisee the right of use of the franchisor’s intellectual property, pre-existing business methods and operating processes and other support services necessary to set up and operate the relevant franchise. Given that a portion of the fees may relate to the right of use of a franchisor’s intellectual property, a question that arises is whether the franchisee would be entitled to claim a deduction of any premium paid thereon in terms of section 11(f) of the Income Tax Act.

Section 11(f) of the Income Tax Act provides for a deduction of a premium or consideration in the nature of a premium for, inter alia, the right of use of any patent, design or trademark or other property of a similar nature, or the imparting of or undertaking to impart any knowledge directly or indirectly related to such property, provided such property or knowledge is used in the production of the payee's income. The allowance granted under section 11(f) of the Income Tax Act is the amount paid for the premium or like consideration divided by the number of years of the lease agreement, but limited to 25 years.

With respect to the availability of a deduction for initial franchise fees under section 11(f), the Draft Guide dismisses this line of argument on the basis that generally initial franchise fees relate to a multitude of services and will not constitute a "premium or consideration in the nature of a premium".

It is submitted, however, that whilst there may be some foundational basis for the deduction, two aspects in particular could prevent the claiming of the deduction by franchisees:

First, the composition of the initial franchise fee would need to be analysed. Only that portion of the payment which is allocated to the use of the intellectual property should be considered with regard to section 11(f). Practically, franchisees would be reliant on the franchisor to provide them with this breakdown. Secondly, as correctly noted in the Draft Guide, the initial franchise fee would need to be in the nature of a 'premium'. The words 'premium' and 'consideration in the nature of a premium' have been interpreted to mean 'consideration passing from a lessee to a lessor, whether in cash or otherwise, distinct from and in addition to, or in lieu of, rent". The amount paid by the franchisee would therefore need to be an amount payable over and above the payments being made by the franchisee for the ongoing right of use of the intellectual property. In order to show that the amount paid is in the nature of a premium, the franchisor would likely be required to perform a valuation of the intellectual property provided and to benchmark the amounts charged for the on-going use of that property to reflect the portion paid by the franchisee that exceeds such benchmark. Franchisees would again be reliant on the franchisors to provide the information required in order to support the tax deduction.

Individual franchisors generally, for consistency and ease of administration, use a standard template franchise agreement which is aligned to their business model and structure. It is doubtful whether a new franchisee concluding a franchise agreement with an established and dominant franchisor would have the leverage to request a breakdown of the initial franchise fee within the agreement (which may deviate from the standard template) and require the franchisor to undertake valuation and benchmarking analyses to determine any 'premium' portion. The determination of the portion, if any, of the initial franchise fee which would be considered 'a premium' and be deductible under section 11(f) would be a complex exercise, over which the franchisee may have little or no control. The ability of the franchisee to obtain the required information to claim a section 11(f) deduction would be determined by the franchisee's ability to place the matter on the agenda with the franchisor and the franchisor's appetite to support the franchisee in this regard. This is an industry challenge that extends beyond, but affects the application of section 11(f).

Royalty payments

Another practical matter facing franchisees which is not considered in the Draft Guide relates to royalty payments. It was held in BP Southern Africa (Pty) Ltd v Commissioner for South African Revenue Service that royalty payments made to acquire the right of use and not ownership of intellectual property were for all intents and purposes indistinguishable from recurrent rent paid for the use of another's property and, on that basis, tax deductible.

The above case must be distinguished from the decision in C: SARS v Kajadas Cosmetics (Pty) Ltd, where it was held that although payments may be regular and ongoing, they would be capital in nature and not tax deductible where they constituted consideration for the acquisition of distribution rights (the income-earning structure of the taxpayer) and were not in any way connected to the operations of the franchise business.

The deduction of royalty payments by the franchisee will therefore be dependent upon the wording of the relevant agreement:

- amounts paid by franchisees for the ongoing use of the intellectual
- property owned by the franchisor should be deductible; whereas
- amounts paid by franchisees (including recurrent expenditure) for the acquisition of intellectual property will be capital in nature and not deductible.

The same view is expressed in the Draft Guide. Yet, the practical aspects faced by a franchisee in order to claim such a deduction are again concerning. The true nature of the royalty payments may not be clearly reflected in the legal agreements with the result that the deduction may be disallowed in the hands of the franchisee. Should taxpayers be unable to deduct the ongoing payments that are made for the right of use of the franchisor's intellectual property and businesses processes, this would have a significant adverse financial impact on franchisees. Again a franchisee's ability to have the franchise agreement drafted to (i) specifically itemise the composition of payments made in terms thereof and (ii) reflect the true intention of the payment is questioned.

4 Lack of Incentives

What is most apparent from the Draft Guide is the lack of tax incentives for the franchise industry as a whole. In setting out the tax implications for both parties to a franchise agreement, the guide highlights that there is often a tax "mismatch" within the industry. Typical franchise payments are taxable in the hands of the franchisor yet not claimable for tax purposes in the hands of the franchisee (refer to the discussion above).

In its Medium Term Budget Policy Statement issued on 21 October 2015 (the 'Statement'), National Treasury noted that more than ZAR 7 billion would be transferred directly from the *fiscus* to support the operations of South African companies.[4] In the Statement, Government confirms that "*particular focus will be given to job creation and the need to incentivise labour-intensive economic activities*".

[4] This support would be in addition to the approximately ZAR 24 billion in tax incentives received by corporates annually. National Treasury further confirmed that a number of additional proposals aimed to increase incentives to the private sector had also been earmarked for consideration.

This is in addition to the Economic Competitiveness Support Programme[5] which was established to ensure that tax incentives have a real impact on economic growth, productivity, competitiveness and strike a balance between trade and employment. The programme will have total allocations of around ZAR 22.7 billion over its six-year period. It is submitted that the extension of tax incentives in favour of the franchise industry could assist in encouraging further growth in an already growing industry.

The introduction of tax incentives within the franchise industry could take various forms: a tax deduction for franchisees of the initial up-front franchise fee over the lesser of a specific period (say ten years) or the term of the initial agreement. Accelerated wear and tear allowances on franchise assets (e.g. 50:30:20) similar to those extended to the manufacturing industry could also be introduced.

The franchise industry is largely labour-intensive and contributes significantly to the skills base of the South African workforce. Yet franchisees and franchisors alike are generally not able to access the so-called 'learnership allowances' provided in the Income Tax Act,[6] as the staff training they conduct is largely not approved by a sector education and training authority. Extending a similar allowance to franchise organisations (either generally or possibly in relation to the 'Franchise Manager' position) may further incentivise franchisees and franchisors alike to increase the level of training already provided.

[5] Introduced in 2011/2012

[6] Refer section 12H. In short, these learnership allowances allow an employer to deduct an annual amount of R30 000 per employee who is enrolled in qualifying training, with an additional allowance of R30 000 per employee on completion of the required training.

5 Conclusion

As stated in the introduction to the Draft Guide, the franchise industry is a major contributor to the South African economy and is growing at a rapid rate. The initiative by SARS to establish clear guidelines as to the tax provisions relevant to the industry as included in the Draft Guide is welcomed. However, in many instances due to the weaker position of franchisees vis-a-vis franchisors, in the drafting of franchise agreements, the tax deductibility of amounts paid by franchisees under franchise arrangements may not be readily accessible. Tax incentives could alleviate this burden and aid, or even facilitate, continued growth in the franchise industry. Against a bleak South African unemployment rate of around 25 percent, the lack of tax incentives for this under-estimated yet growing industry becomes even more glaring.

This article was first published in the ***Business Tax and Company Law Quarterly*** (ISSN 2219-1585), vol 7; issue 2 (June 2016) and is reprinted here with permission from the publishers, Siber Ink. See http://www.siberink.co.za/pISSN2219-1585/Business-Tax-and-Company-Law-Quarterly.aspx for details about this publication.

Contact us

Lesley Bosman
Associate Director, Corporate Tax
T +27 82 719 5523
E lesley.bosman@kpmg.co.za

Jenna Mason
Senior Manager, Corporate Tax
T +27 63 682 1387
E jenna.mason@kpmg.co.za

www.kpmg.com