DEDUCTIONS OF ROYALTIES, FRANCHISE FEES AND THE *ITC 1798* RULING

By Naomi Chirwa.

HRXNAO002

October 2006

Research dissertation presented for the approval of Senate in fulfilment of part of the requirements for the Master of Philosophy (Tax Law) in approved courses and a minor dissertation. The other part of the requirement for this qualification was the completion of a program of courses.

I hereby declare that I have read and understand the regulations governing the submission of Master of Philosophy dissertations, including those relating to length and plagiarism, as contained in the rules of this University, and that this dissertation conforms to those regulations.

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1. INTRODUCTION

A royalty is generally defined as a payment made for the use or right to use the property of another person such as intellectual property in form of a book or an invention for gain.[1] The term royalty is not defined in the Income Tax Act, but section 35 of the Income Tax Act, which deals with taxation of non-residents' royalties or similar payments from the Republic, gives an idea of what constitutes a royalty. The definition to be construed from this section is more or less the same as the definition above.

This paper seeks to critically analyse the Tax Special Court (the lower court) and Supreme Court decisions in the case of *BPSA (Pty) Ltd V C: SARS.*[2] The issue for determination in this case was whether the royalties incurred by BP SA (Pty) Ltd were capital or revenue in nature. In particular, both courts considered the question, whether the deduction being sought by the appellant was not deductible under section 11(a) of the Income Tax Act.[3] The lower court held that the royalties were capital in nature and not deductible. The Supreme Court found that royalties were of revenue nature and deductible. In this paper, I argue that the lower court's judgement was more convincing than the Supreme Court's.

2. BRIEF FACTS OF *BPSA (PTY) LTD V THE COMMISSIONER FOR SARS*

BPSA, the appellant was incorporated in 1924 under the name Atlantic Refining Company of Africa Limited. In 1959, it changed its name to BP Southern Africa Pty Ltd (BPSA). BPSA was a wholly owned subsidiary of BP plc until 2001. Pursuant to a Black Economic Empowerment Deal, BP Plc sold 25% of its interest. It has since held 75% of BPSA's company shares. BP Plc is registered in England and Wales.

BPSA operates as a manufacturer, supplier and marketer of petroleum products and dominated specific market in the country. It uses brand names owned by BP Plc,

[1] "Definitions of royalty on the web" Available at www.promitheas.com/grossary

[2] *BPSA (Pty) Ltd v The Commissioner for SARS* [2007] SCA 7 (RSA) Para 13, See also ITC 1798 (2005) 64 SATC 9.

[3] Section 11(a) of the Income Tax Act, provides that any expenditure and losses actually incurred in the production of income, which are not of a capital nature, are allowable as deductions for purposes of determining taxable income derived by a person from carrying on any trade in South Africa.

colour scheme, designs and symbols (the licensed marketing indicia). These marks have been used since 1959 free of charge.

In 1979, there was an agreement, which licensed the appellant to use the licensed marks non-exclusively. This agreement was further based on condition that BP plc could, at any time, give notice to appellant to enter into negotiations regarding payment of a royalty for the use of its marks. In 1996, BP plc made a decision that all users of its licensed marks and licensed marketing indicia should be required to pay a royalty.

In 1997, an agreement between BPSA and BP Plc was concluded. In terms of the agreement, the appellant was granted a personal non-exclusive and non-assignable authorisation to use the licensed marks and licensed marketing indicia. BP plc remained the sole rightful owner of these licensed marks and licensed marketing indicia. All rights and goodwill attaching to or arising out of the use by the appellant of licensed marks and licensed marketing indicia accrued to the benefit of the BP plc. Upon termination, the appellant would no longer be entitled to use the licensed marks, licensed marketing indicia and the name 'BPSA'. Furthermore, the agreement restricted the territory where appellant could use the licensed marks and licensed marketing indicia to South Africa. In consideration for this, the appellant paid annual royalty fees expressed as rate per volume of petroleum products sold. This agreement endured for two years. Thereafter it was supposed to be automatically renewed for the successive twelve months unless terminated by either of the parties by giving six months notice or by reason of a breach.

The appellant made royalty payments of about R42 million annually for the years 1997, 1998 and 1999. These amounts were claimed as deductions in calculating taxable income for the appellant. The Commissioner disallowed the deduction of royalties and the appellant objected and consequently appealed against the disallowance of the royalties in question. This led to the case in court. The issue for determination was whether the royalties incurred by the appellant under the 1997 agreement were deductible in terms of section 11(a) of the Income Tax Act and in particular whether the deduction being sought by the appellant was revenue or capital

in nature. I now present the judgements of the two courts starting with the lower court.

3. THE LOWER COURT JUDGEMENT

As noted above, the issue in this case revolved around whether the royalty payments were capital or revenue in nature. The lower court held that the royalty payments were not deductible because they were found to be of a capital nature. The court came to this decision by determining what the purpose of the expense was. According to Judge Waglay of the Tax Court, the purpose was maintenance of the appellant's market share which was held to be closely connected to income earning structure than the income earning operations. The lower court compared the trademark license that BP SA had with BP Plc to a franchising agreement. The tax commentators did not agree with the lower court's ruling because they reasoned that the royalties, which are likened to on going fees, are not capital in nature.[4]

4. THE SUPREME COURT JUDGEMENT

As was the case in the lower court, the issue for determination was whether the royalties paid by BPSA to BP Plc in terms of the 1997 agreement were not of capital nature and deductible. The Supreme Court held that the royalty payments were revenue in nature and deductible. This court arrived at this conclusion by examining the purpose of the expense as well. It should be noted that the Supreme Court did not compare the Trademark license agreement that BPSA had with BP Plc to a franchising agreement as the lower court did, hence the difference in the outcome of purpose. The purpose of the expense was found to be for the use of the licensed trademarks and licensed marketing indicia.

5. THE LAW AND DEFINITIONS OF CONCEPTS

5.1 Franchising

Franchising is defined as a sophisticated form of licensing in terms of which the franchisor licences its intellectual property including its trademarks, trade dress, copyright, know-how, trade secrets, business concept, methodologies and if required,

[4] These commentators include: C Monteiro, J Silke, D Clegg and D Erasmus.

designs and patents to the franchisee.[5] Other writers have defined a franchise as a business arrangement wherein one party, namely, the franchisor, enters into a contractual relationship with another party namely, the franchisee, granting the franchisee rights to use the franchisor's trade name and trademarks and to conduct a business in accordance with a specified format.[6] Simplistically, a franchise would be described as a business whereby one is allowed to trade under a well known name or trademarks and in consideration of a stipulated amount of fees.

A franchisee is therefore the recipient of a franchise and the franchisor is the giver or the owner of the franchise.[7] If a franchisee enters into a franchise agreement, in exchange for a franchise, the franchisee pays the franchisor an initial fee and ongoing management fees, which are sometimes called royalties.[8] Daniel Erasmus[9] has highlighted four relationships that franchise business operations give rise to. These are a branch office, a wholly owned subsidiary, a joint venture and a local partner operating under a licence of the master franchising agreement.

The payment of the initial fee or upfront fee, which is normally fixed, grants the right to the franchisee to operate in a particular area or the right to trade under the name of the network, using the network's trademarks, trade connections and accumulated know-how for a specified period.[10] Illetschko[11] notes that in return for the on-going payment of the management services fees or royalties, the franchisee is entitled to receive the on-going guidance, training and support in operating the franchisor's business and advertising. According to Erasmus,[12] these on-going payments are for the maintenance of the use of the exclusive area and the intellectual property. However, they are variations in the way these payments are structured, which may have important tax implications. For example, some are structured in such a way that there is no initial start-up fee, but a higher annual or monthly fee.[13]

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[5] Web definitions available at www.johnandkernick.co.za, accessed on 05/10/06.
[6] Silke Jonathan, "Royalties are not rentals" (2006) *20 Tax Planning 66*, at 71.
[7] Illetschko Kurt "Becoming a Franchisor" Available at www.frain.org.za, accessed on 31/09/06.
[8] Ibid.
[9] Erasmus Daniel, "Royalties (franchise fees) and their deductibility" available at www.taxtalk.co.za, accessed on 30/09/06, at 2
[10] See Illetschko Kurt, note 7, above, Para 11.2
[11] Ibid.
[12] See Erasmus D, note 9, above at 5
[13] Ibid.

5.2 Tax implications of the fees paid in a franchise agreement.

As far as case law is concerned, the initial fee discussed above is of a capital nature and not deductible in terms of section 11(a)[14] of the Income Tax Act. This is so because it is expended in order to establish or create an income-earning structure. It gives a franchisee the right to trade in a specified area or under the name of the network. For example, in *Commissioner for South African Revenue Service v Kajadas Cosmetics (Pty) Ltd,*[15] where the issue under contention was whether the annual fees being paid to secure a licence for an exclusive distribution of beauty products were deductible or not. The Transvaal Provincial Court held that the exclusive distribution rights acquired created an income earning machinery and, as such, was of a capital nature and not deductible.

Similarly, in *ITC 1726,*[16] an initial basic fee for the licence to conduct a non-exclusive cellular service for a renewable period of 15 years was paid before the business operations started. It was held that the initial licence fee was more closely connected to the income-earning structure than income-earning operations. It was therefore, held not to be deductible. However, the on-going annual licence fee was held to be recurrent expenditure and deductible in terms of section 11(a), being more related to income-earning operations.

The same principle was echoed in *ITC 1224,*[17] where the legal costs incurred in connection with applications for licenses for the new branches were held to be of a capital nature and not deductible. These were distinguished from the recurrent expenditure incurred in obtaining annual renewals of such licences. It was held that the acquisition of licenses for the new branches was for the right to operate a business and this was closely connected to the income earning structure.

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[14] This section is discussed in more detail in part 5.3 below.
[15] 2002 (4) SA 709 (T) 64 SATC 200

[16](2000) 64 SATC 236
[17] (1974) 37 SATC 30 (T)

Having said that, it should be noted, however, that the non deductible initial start up fee, paid by the franchisee, may nevertheless be claimed as a deduction in terms of section 11(f) of the Income Tax Act. This section provides for deduction of premiums or royalties for the right of use of a patent, design or trademark.

From the preceding paragraphs, it can be concluded that, if the expenditure is incurred for the purpose of acquiring a capital asset for the business, as is the case with the initial fees in a franchise agreement, the expense is capital in nature even if paid in annual instalments. Therefore, the payment made for the right to operate a business, even if paid in annual instalments is of a capital nature as it is incurred for the purpose of acquiring a capital asset. Furthermore, the on-going fees or royalties in a typical franchise agreement are allowable, because they are closely linked to income-earning operations.

5.3 When Is An Expense Deductible?

In terms of section 11(a) of the Income Tax Act, 'expenditure and losses actually incurred in the production of income, which are not of a capital nature, are allowable as deductions for purposes of determining taxable income derived by a person from carrying on any trade'. However, 'no deductions may be made with respect to any moneys claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade'.[18]

The terms 'actually incurred,' 'in the production of income' 'for the purposes of trade' and 'not of a capital nature' contained in the general deduction formula are discussed hereafter giving more emphasis to "not of a capital nature"

5.3.1 Not of a capital nature

'Not of a capital nature' means that the expenditure must be revenue in nature. The distinction between revenue and capital is illustrated in a number of court cases discussed below, in which a range of tests for determining whether an expense is of a

[18] Section 23(g) of the Income Tax Act in "Professional tax hand book," fifteenth ed. Butterworths: Durban (2005/2006).

capital or revenue nature were developed. The guiding principle in these cases is that one has to look at the facts of each case and purpose of the expenditure concerned in order to ascertain whether the expense is revenue or capital.[19]

The first test is found in *New State Areas Ltd v CIR,*[20] where it was stated that, for an expense to be deductible, one has to prove that the expense formed part of the cost of performing the income earning operations (which is revenue or non-capital). If it formed part of the cost of establishing or improving or adding to the income-earning structure, then it is capital and not deductible. Therefore, expenditure will rank as revenue in nature if it is closely linked to the taxpayer's income-earning operations and forms an integral cost of those operations.[21] Expenditure will be capital in nature if it is closely linked to the income-earning structure, which enables him to generate income.[22]

The second test is found in the case of *CIR v George Forest Timber Company Ltd*[23] where it was held that:

> money spent in creating or acquiring an income producing concern must be capital expenditure. It is invested to yield future profit and while the outlay does not recur the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it.[24]

It was further stated in the above case that any expenditure, which has the effect of increasing the taxpayer's ability to generate income in the future over a period of time, is of a capital nature, while expenditure which is linked to the day-to-day activities is revenue in nature.[25] In considering the nature of the expenditure and its link to the capital structure of the taxpayer, it has been said, that it is important to

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[19] SIR v Cadac Engineering (1965) 27 SATC 61 at 73

[20] New State Areas LTD v CIR at 163-164,Nchanga Consolidated Copper Mines v COT (1962) 24 SATC 469, COT v Rhodesia Congo boarder Timber (PTY) LTD (1962) 24 SATC 602 at 612

[21] De Koker, Silke *on South African Income Tax*, 10th edition, Vol. 1, Para. 10.2.9

[22]

[23] (1924) 1 SATC 20

[24] Ibid at 25-26 See also COT v Rhodesia Congo Boarder Timber (PTY) LTD (supra) at 608.

[25] De Koker, Silke *on South African Income Tax*, 10th edition, Vol. 1, Para. 10.2.9

distinguish between fixed capital and circulating capital.[26] Where there is a continuous switch between cash and assets, as part of profit earning operations, the assets are regarded as circulating capital and any expenditure linked to such capital is revenue in nature.[27]

The third test developed by English Courts for deciding whether an expense is revenue or capital in nature asks the question whether the expenditure was a once and for all expense or one that was likely to recur?[28] The former is capital while the later is revenue. However, some 'once and for all' expenditure can qualify as revenue. For instance rental payment for the business offices can be paid as a lump sum for the whole year and qualify to be revenue in nature. In *New State Areas,*[29] it was stated that

> the true nature of the transaction must be enquired into in order to determine whether the expenditure attached to it is revenue or capital 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 business it is a capital expenditure even if it is paid in annual instalments; if on the other hand, if 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 revenue expenditure even if it is paid in a lump sum.[30]

In summary, what is important is the nature of the transaction not the mode of payment.

Fourth test to look at is the enduring benefit test, also developed by English Courts. This requires one to enquire whether the expense has the effect of bringing into a trade an enduring benefit.[31] The enduring benefit test principle states that:

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[26] Ibid.
[27] Ibid.
[28] See De Koker, note 25, above, Para 7.9, 7-24.
[29] New State Areas LTD v CIR at 163-164
[30] New State Areas LTD v CIR at 163-164See also Nchanga Consolidated Copper Mines v COT (1962) 24 SATC 469, COT v Rhodesia Congo boarder Timber (PTY) LTD (1962) 24 SATC 602 at 612
[31] See De Koker, see note 25, above, Para 7.9, 7-24.

> But when an expenditure is made, not only once and for all, but with the view to bringing an asset or advantage of the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but capital.[32]

If the benefit from the expense is of a temporary nature, then the expense is revenue. If it is of an enduring nature, the expense is capital. The case of *SIR v John Cullum Construction Company Limited*[33] illustrates the application of this test. The taxpayer incurred some expenses in getting rid of a contract that had become an undue burden. It was held that the benefit was temporary and, consequently, the expense was held to be revenue and deductible.

Lastly, the Hallstrom principle test[34] was developed by the Australian courts. This test classifies an item to be capital or revenue in nature from 'a practical point of view and not from juristic classification.' This principle is not new to South African tax case law. It has been cited with approval in a number of cases. In *Estate AG Bourke v CIR*[35] Hoexter JA stated that *the labelling of capital in either category at a given time and in a particular situation does not impart any ingrained character, incapable of fluctuation, to capital involved.* In *C: SARS v Van Blerk*[36] judge Davis said *the enquiry relates not to the legal classification of the thing sold, that is whether it is part of the corpus, or constitutes a sale of fructus but exclusively to the nature of any business carried by respondent in relation to such sand.* In C: *SARS v Kajadas Cosmetics Pty Ltd*[37] judge Roux said *what is an outgoing of capital and what is an out going of revenue depends on what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.*

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[32] British insulated and Helsby Cables Ltd v Atherton (1926), AC (1925) All ER 623
[33] SIR v John Cullum Construction Company Limited (1965) 27 SATC 155 at 174
[34] *Hallstrom Pty ltd v FCT* (1946) 3 AITR 436; 72 CRL 634 at 648
[35] (1990)53 SATC 86
[36] (2000) 62 SATC 131
[37] 2002 (4) SA 709 (T) 64 SATC 200

In summary, an expense will rank as capital nature if it is spent in order to add or improve or establish an income-earning structure. In other words, all the expenses which have the effect of acquiring or creating a source of income will be of a capital nature and not deductible in terms of section 11(a). Care should be taken when using the enduring benefit and recurrent tests because these are not conclusive. The true nature of the expense has to be looked into before any conclusion is reached.

5.3.2 Actually incurred

An expense will be regarded as having been 'actually incurred' whether a taxpayer conducted the business inefficiently or not, as long as it is shown that the expense was incurred for business purposes.[38] It has also been held that 'incurred' means either 'paid' or 'become liable for.'[39] According to the judgement in *Caltex Oil (SA) Ltd v SIR*,[40] 'expenditure actually incurred' means 'all expenditure for which liability has been incurred during the year'.

5.3.3 In the production of income

Generally, 'in the production of income', means that the purpose of the expenditure has to be that of earning income.[41] Not only must the expense be closely linked to the income earning operations of the business it must also be incurred in good faith for business purposes.[42]

It should be noted that there is no legal requirement that an expense must produce income for it to be allowed as a deduction. As Centrivres CJ said in *Sub-Nigel*,[43] *The mere fact that no income has actually resulted is in my view irrelevant; the purpose was to obtain income on the happening of the fire, which would prevent the carrying of the income producing operations.*

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[38] *Port Elizabeth Tramways Company Limited v CIR* (1935) 8 SATC 13, 15.
[39] ITC 542 (1942) 13 SATC 116
[40] 1975 (1) SA 665 (A)
[41] See De Koker et al, note 25 above, Para 10.2.7
[42] *Port Elizabeth Tramways Company Limited v CIR* (1935) 8 SATC 13. In this case the taxpayer was a transport company. The driver of one of its trams was involved in an accident and as a result the driver died. The company was compelled to pay compensation to the driver's dependents. The court held that the expense was closely linked to the income earning operations hence in the production of income. See also *CIR v Nemojim (PTY) LTD* (1983) 45 SATC 241 at 256.
[43] Sub-Nigel v CIR (1948) 15 SATC 351 at 390-391

The same view was expressed in *CIR v Allied Building Society*[44] where it was stated that the court is not concerned with whether 'a particular item expenditure produced any part of the income, but with whether that item of the expense was incurred for the purpose of earning income.'

Therefore, it is submitted that in order to determine that the expenditure is incurred in the production of income, the court will look at the purpose of the expenditure. This will, in turn reveal whether the expenditure is closely linked to the income-earning operations or not.

5.3.4 For the purposes of trade

'For purposes of trade' means that the purpose of the expenditure has to be a business motive with the aim of making a profit. Section 23(g) of the Income Tax Act is an anti-avoidance provision which prohibits the deduction of any moneys claimed as a deduction from income derived from trade to the extent that they are not laid out or expended for the purposes of trade. The test to be applied in order to determine whether the expenditure has been expended for the purposes of trade is the profit motive.[45] However, if the taxpayer can show intention or expectation of deriving a profit from the trade, then the profit motive is satisfied.[46] One does not have to show actual profit.

If it is found that the expense is expended partly for the purposes of trade and partly not, the expense is apportioned proportionally to revenue and capital.

6. ANALYSIS OF THE JUDGEMENTS

6.1 Introduction

As noted earlier this case dealt with the deduction of royalty payments from a subsidiary company to its controlling shareholder BP plc. The payments were paid for the use of the licensed trademark and licensed marketing indicia owned by the controlling shareholder. The payments were held not to be deductible by the lower court because they were found to be of a capital nature. However, the appellate

[44] (1963) 25 SATC 343
[45] Ibid at 10.2.8
[46] Ibid

division held that these royalties were deductible and not of a capital nature. The following paragraphs will give an analysis of both judgements.

6.2 The Lower Court Judgement

Firstly, the lower court considered the question whether the royalty payment had the effect of bringing into trade a right or advantage of an enduring nature. BPSA contended that the expenditure in question was not of a capital nature because ownership of the licensed marks and licensed marketing indicia vested in BP plc. Moreover, it obtained no enduring benefit as the contract was terminable on six months notice. Furthermore, the costs to procure the use of the licensed marks and licensed marketing indicia were recurrent annually.

The Commissioner argued that the annual payments made by appellant was for the right or advantage of an enduring benefit to its trade and of a permanent character and the possession of it was essential to the appellant's business operation. The Commissioner relied on the case of *CIR v African Oxygen Ltd,*[47] where it was stated that:

> it is evident from the terms of the agreement itself that the parties contemplated the possibility that it would continue for an indefinite period...The extent of the advantage which accrued to the respondent should, I consider, be determined in relation to the position at the inception of the agreement, which was also the inception of the advantage.... It is not unlikely, moreover, that any advantage gained during that period by way of a stabilized or increased goodwill, would not lapse at the end thereof, but would, although to a gradually diminishing extent, persist for sometime thereafter. The payments in whatever year they were made, were for an asset which came into existence once and for all at the inception of the agreement, and the liability to make them was undertaken in order to secure the advantage of the asset for the full term of the agreement.

[47] 1963, (1) SA 681 (A), 25 SATC 67 at 76-77.

The court in tackling this argument agreed with the Commissioner's submission by scrutinizing the trademark license agreement. The agreement, which lasted for an initial period of two years and was thereafter renewable every twelve months, was held to confer an advantage or right of an enduring benefit.

One of the tax commentators, Carla Monteiro,[48] is of the opinion that the court erred because it can hardly be said that the annual payments, in terms of the trademark license agreement, granted appellant an enduring benefit. She submits that if the appellant defaulted one of the said payments, it would no longer be entitled to use the trademark licenses. Therefore, she argues that the benefit only endured for the period for which payment was made.

It is submitted that Monteiro's argument is valid if one considers that payments were paid for the use of the trademark licence only. However, the expense seems to be a compound one, if the true nature of the transaction is examined. As earlier mentioned, it was stated in *New state areas v CIR*[49] that in order to determine whether a particular expense is closely related to the income-earning operations or to the income earning structure, the true nature of the transaction must be looked into. There are some capital elements hidden in these royalty payments such as payments for maintaining the competitiveness of the business, which effectively constitutes the maintenance of market share.

It is further submitted that the enduring benefit test, used by the lower court, does not ask the question what the expense was for. But rather what advantage or benefit or asset emanated from the expense. If the advantage is of an enduring nature, then it is of a capital nature and not deductible. In order to establish what advantage was sought by the appellant in paying the royalties, the reasons as to why the appellant concluded the agreement has to be looked into. The main reason was to remain competitive and this would be achieved by maintaining the brand name and identity and building on past reputation, which in turn would enable the enhancement of customer royalty. Therefore, the main advantage emanating from the royalty payments was to protect

[48] Carla Monteiro "Royalty deductions: is the end nigh?" Available at www.wwb.co.za, accessed on 10/09/06

[49] See New state Areas V CIR note 20 above.

the market share already in existence and build on it. The market share is closely connected to the income earning-structure. Therefore, this clearly points to the fact that the payments were of a capital nature. It is settled law that any expense paid in order to protect or maintain a capital asset is capital in nature and not deductible.[50] In *casu*, the payment could have been for the use of the trademark licence and the marketing indicia but the advantage sought was the maintenance of reputation which BPSA had built in the past. This maintenance of reputation was of a capital nature because it had an enduring benefit. The benefit would surely endure for the whole period that the licensed trademark and the marketing indicia were in use up to the time the agreement is terminated. If one payment is defaulted the reputation would still be there as long as the agreement is not terminated. However, if on the other hand, the trademark license agreement was terminated, the whole income-earning structure of the BPSA would be at stake.

It should also be noted that the enduring benefit test has one major weakness. There is no standard as to how long should the period be before it can be declared to be an enduring one. The period depends on the facts of the case. It is submitted that, as far as the facts of this case are concerned, the advantage obtained from the trademark licence agreement is long term one despite it being structured in bits of time. If one takes into account the fact that appellant is a subsidiary of BP plc, the owner of the trademarks, one wonders how they would want BPSA to trade under a different trademark. It is my submission that the agreement would endure forever.

BPSA also contended that the royalty payments for the use of incorporeal property such as trade marks, patents and copyright can never be expenditure of a capital nature, because, if it were, there would have been many reported judgements on the subject. This contention was without substance. In my opinion, the court cannot rule that a particular expense is revenue in nature just because they are no reported judgements on the subject at hand. The court has to apply the right tests such as the one relied on by the Commissioner. Moreover, the franchising business has evolved so much that the contracts governing these businesses are different from those used a century ago. As already mentioned in part 5.1 of this paper, parties can vary the

[50] CIR v VRD Investments (Pty) Ltd 1993 (4) SA 330 (C)

parameters of the contract to such an extent that it becomes difficult to classify expenses as revenue or capital. The court was aware of this fact. That is why it evoked the *Hallstrom principle* (categorizing income from a practical point rather from a legal classification) in order to discover the real nature of the expense in question. The court must be commended in taking into account the practicality of the matter.

On the first question, the lower court held that BPSA had incurred the expense in order to maintain and increase its market share. The expense was further held to be a right or advantage of an enduring nature because it protected and promoted the core of BPSA's business.

Secondly, the lower court considered the issue whether the fact that the trademarks belonged to BP plc and not BPSA meant that the expense was revenue in nature . The lower court found that in deciding whether an item is capital or revenue in nature, it is immaterial whether the asset belongs to that person or not. It should, however, be noted that some writers are against the lower courts decision. For example, Monteiro states that the fact that the asset in question was not owned by that particular person is a strong indication that such asset does not contribute to the income earning structure of such a person.[51]

It is, however, my submission that Monteiro's point has got its demerits. In order to know whether the expense is capital or revenue in nature, all the tests do not look at ownership but how one is dealing with the asset.[52] If an asset is used as a 'source of income,' even if it does not belong to the taxpayer, it is considered to be capital in nature. On the other hand, if it is used in 'working a source of income,' it is considered to be revenue. Capital or revenue tests have nothing to do with ownership.

In reaching the above decision, the lower court in *BP SA v C: SARS* [53] relied on a tax court case *A v COT.* [54] Here, a person leased a piece of land and spent money to erect buildings to be used in his farming business. The expense in question was held to be

[51] See monteiro note 48 above.
[52] See the *Hallstrom* Principle test, the enduring benefit test, the George Forest timber Principle, and New State Areas Test in part 5.3.1 above. See also *C: SARS v Van Blerk*, 63 SATC 131.
[53] *BPSA (Pty) Ltd v The Commissioner for SARS* [2007] SCA 7 (RSA) Para 13
[54] 19 SATC 29 at 33

of a capital nature even though the property in question belonged to the lessor and not the farmer.[55] The court a quo cited the following from *A v COT*;

> The benefit created by the expenditure must, in each case, be related to the trade itself. During the currency of the lease, the appellant's 'trade' is, *inter alia,* that of a tobacco farmer; during that time he will enjoy the benefits resulting from the buildings he has erected , and the right to the enjoyment of the benefits created by their presence upon the farm is unquestionably his property. I cannot see how ownership of the buildings could increase the benefits or appellant's enjoyment of them. The right of enjoyment of the benefits forms part of the appellant's fund of capital assets and of the equipment of the income-producing machine. I conclude, therefore, that it is immaterial that he does not own the corporeal assets from which the benefits flow.

It is my submission that although this decision has no binding effect on the lower court, it represents the correct interpretation of the law.

On the second question, the lower court held that it is immaterial whether the licensed trademarks and licensed marketing indicia belonged to BPSA or not.

Thirdly, the lower court considered the question whether BPSA and BP Plc can be likened to landlord-tenant relationship. BPSA contended that its position, in relation to BP plc, was likened to that of a tenant and landlord. The royalty payments constitute nothing but a rental payment for the use of BP plc properties. The lower court rejected this analogy. Firstly, it stated that, without these licensed marks and licensed marketing indicia, the appellant would not be in a position to trade. The lease or rental arrangement does not provide for such thing even in the cases where the lease offers the tenant a good trade location. Secondly, the nature of the property itself is different in that a trademark is a result of intellectual application of one's mind which is specific and unique. The lower court held further that the trademark carries with it a reputation associated with the product whereas a fixed asset does not. Moreover, the trademark gave the appellant structure and goodwill without which it would have been unable to trade.

[55]See ITC 1798, note 2 above.

Commenting on this holding, David Clegg[56] is of the opinion that the payments made for the use of the property must inherently be more closely related to the conduct of the business operations than the creation of its capital structure. He argues that the appellant's payments did not acquire the asset or right of use but paid for its use. Jonathan Silke[57] is of the opinion that the court erred in *BPSA (Pty) Ltd V C: SARS* in holding that royalty payments were capital in nature, because appellant did not acquire an asset but a contractual right of use. He further contends that, the appellant's contractual right of use was of a short duration and the payments were recurrent annually. Additionally, he states that the payments were linked to the sales volume.

Daniel Erasmus[58] argues that, in a typical franchise agreement what the franchisee acquires is the right of use from time to time of an intellectual property. He further contends that this right should be regarded as the part of the cost of performing the franchisee's income-earning activities and therefore revenue in nature. He argues that in *BPSA (Pty) Ltd V C: SARS*, no proprietary rights were acquired but only the right of use and, as a result, the royalty payments in question should have been of a revenue nature. However, he concedes that some 'franchisor and franchisee agreements' do not have the typical initial start up fee but a higher annual or monthly fee.

On the other hand, Carla Monteiro[59] is the opinion that the appellant's analogy of landlord and tenant was a good one because a good trade location afforded by the lease is no different to the trade advantages afforded by the trademark and that the deductibility of rent has never been challenged.

The arguments put forward by Erasmus, Silke and Clegg, it is my submission, that they have the same effect. They all make the point that the appellant acquired the right of use of the trademark licence, which should be treated as revenue in nature. As earlier mentioned, in a typical franchising agreement, the franchisor basically dictates how the business should be run.[60] This should be differentiated from a trademark

[56] Clegg David, "Franchising frights" (2006) *20 Tax Planning 36* at 37.
[57] See Silke Jonathan, note 6 above.
[58] See Erasmus, note 9 at 5, 11
[59] See Carla Monteiro, note 48 above.
[60] Intellectual Property, available at www. uct.butterworths.co.za, accessed on 10/09/06 page 1502

licence agreement, which involves only the use of trademarks. The franchisor does not dictate how the business should be run.[61] The court a quo did not make this distinction in its ruling. It is submitted that BP SA had a trademark licence agreement which is also part of a franchising in a smaller picture.[62] However, the initial start up fee was not included in the agreement. This fee then, as conceded by Erasmus, should be built in the higher annual royalty payments. However, the absence of the initial start up fee means that the royalties, even though based on sales volume, included some capital element, for example, authorization for the right to use or purchase price for the acquisition of the right to use the trademark. Thus the arguments of Erasmus, Silke and Clegg do not hold water, as the royalty payments in question were not only for the right of use of the trademark licence but also for the right to operate which is capital in nature.

On the other hand, Monteiro position cannot stand as well. According to the law, as discussed already, good trade location gives the business goodwill but it does not give structure and identity as a trademark. As noted from the discussion above, there is a difference between intellectual property and fixed property. The use of the former brings in a lot more advantages than the latter. Moreover, the advantages emanating from the rental of 'tenant and landlord' is usually of revenue nature while that from intellectual property, as in the case of the BPSA in *casu,* is of capital in nature. Therefore, the court was right in differentiating between the two.

On the question whether BPSA and BP Plc relationship on the use of the trademarks, should be likened to a landlord tenant relationship, the lower court held that BPSA was misconceived because the trademarks is an intellectual property offering more advantages[63] than the rental of a fixed property.

6.3 The Supreme Court Of Appeal Judgement

As in the lower court, the issue under determination was whether the royalty payments paid by BPSA to its controlling shareholder BP Plc were revenue or capital in nature.

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[61] Ibid.
[62] Ibid.
[63] Advantages over rental of fixed property include structure and identity.

The Commissioner contended that the short duration required for termination of the agreement after the initial period should not be given significant weight because of the special relationship that existed between BPSA and BP Plc. However, the Supreme Court was of the view that to engage in such speculation would be an act of grave foul because the parties did not conceal their intention and SARS did not contend that the transaction was simulated.[64]

As in the lower court, BPSA contended that the expenditure in question was not of a capital nature because ownership of the licensed marks and licensed marketing indicia vested with BP plc. Moreover, it obtained no enduring benefit as the contract was terminable on six months notice. Furthermore, the costs to procure the use of the licensed marks and licensed marketing indicia were recurrent annually.

The Supreme Court held that the royalty payments were revenue in nature and deductible. It also found that the royalty payments' purpose was to procure the use and not ownership of the intellectual property.[65] It further held that, for all intents and purposes, the royalty fees were indistinguishable from recurrent rent paid for the use of another's property. It stated that the royalty payments neither created nor preserved any asset in the hands of the taxpayer.

It is my submission that the Commissioner had a point. BPSA and BP Plc are connected persons and as such there is always that special relationship that affects their transactions. This is the reason why even in the Income Tax Act, connected persons usually have special rules. This agreement therefore had all the qualities that it would endure for a longer time period if one considers the fact that BP Plc was the controlling shareholder. As earlier mentioned, there is no way it would allow that BPSA should operate under a different trademark. Therefore, the 1997 agreement had all the potential to last for longer duration than that stipulated in it.

Secondly, the court found that the recurrent nature of the payment was a strong indicator that the expense was revenue in nature rather than capital. It further held that

[64] Ibid. Para 11
[65] *BPSA (Pty) Ltd v The Commissioner for SARS* [2007] SCA 7 (RSA) Para 13

the recurrent cost of procuring the use of something which belongs to another is usually of a revenue nature.[66] The royalty payments in question were held not to have created nor preserved any asset in the hands of BPSA and were in distinguishable from any rent paid for the use of another's property.[67]

It is submitted that the court did not pay much attention to the true nature of the expense in coming up with its purpose. It is not disputed that the recurrent nature and lack of ownership are important considerations in deciding whether an expense is revenue or capital in nature. However, these features are not conclusive but the conclusive test is purpose. This purpose is usually found by scrutinizing the true nature of the transaction. The use of these licensed trademarks and licensed marketing indicia brought about reputation and goodwill to BPSA. This goodwill is a capital asset and an essential part of BPSA income-earning structure. It does not matter whether this goodwill belonged to BP Plc or BPSA but the fact is that there is a benefit emanating from the expense which is of an enduring benefit and would persist for sometime even after termination of the agreement. Moreover, the expense has the effect of adding a capital asset to BPSA's business. It is further submitted that no reasons were given by the Supreme Court in holding that the use of the trademark was in distinguishable from any rent paid for the use of another's property.

7. CONCLUSION AND OBSERVATIONS

Firstly, this paper has looked at both the Special Tax Court and Supreme Court decisions. The question that was being asked was whether the royalty payments paid by BPSA to BP Plc were capital or revenue in nature. The paper has demonstrated that two courts reached at different conclusions. The lower court found that the royalty payments were of a capital in nature and not deductible. The Supreme Court found that the royalty payments were revenue in nature and deductible. Both courts in reaching their decision looked at the purpose of the expense. The lower court found that the purpose of the expense was 'maintenance of market share' because the agreement was compared to a franchising agreement. The Supreme Court found that the purpose was 'the use' of the licensed trademark and licensed marketing indicia.

[66] This fact has already been addressed on pages 17 and 18 of this paper.
[67] Ibid. Para 14 and 15

Secondly, it is my submission that the outcome of the Supreme Court might have been influenced by the tax consultants and commentators of which most of them are tax planners who were of the view that the court a quo finding was incorrect. The aim of most of these tax planners is to reduce their clients' tax liability using every loophole that the can find in the Income Tax Act. From the lower court's judgement, it is clear that most of the tax consultants and commentators were unanimously of the view that the finding is incorrect. They thought that the various tests that the court applied in deciding whether an expense is of revenue or capital in nature did not support the conclusion it reached.

It is my submission that these commentators arrived at this conclusion because they were applying the enduring benefit test wrongly. They applied it to what the expense was paid for. The court applied this test to the advantage that emanated from the expense and rightly reached at the conclusion it did. It is submitted that this is the right way of applying the enduring benefit test.

However, the lower court's dictum did not mean that royalties were out rightly not deductible. Royalties for the right of use of a trademark are deductible in terms of section 11(a) if they are considered to be part of the cost incidental to the income-earning operations. It has to be noted that this case dealt with a special kind of royalty, which involved the use of the intellectual property. It is submitted that the use of intellectual property brings in some rights such as rights for structure and identity. This is why the user has to pay an initial fee for the authorisation to use those rights which is usually a capital payment. Ordinary renting of properties such as buildings lacks this element.

Therefore, it should be noted that the crucial issue about the deduction of royalties in franchising businesses hinges on the agreement's structure. The agreement has to stipulate clearly what purpose the royalty is paid for. If it is paid to acquire the market share it would not be deductible because it is of a capital nature. If it is paid for the use of the intellectual property, the cost would be regarded as incidental to the income-earning operation and would definitely not give the taxpayer a benefit of an enduring nature. Lastly, it is better to structure the agreement so that there is an initial fee and on going fees.

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