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Technical Advisory Services
Tax · IFRS

Tax developments

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In the pipeline: Draft guide on taxation of franchisors and franchisees

Based on the increasing number of franchise arrangements and the contribution of these arrangements towards economic activity in South Africa, SARS has developed and released a *Draft Guide on the Taxation of Franchisors and Franchisees* (hereafter the draft guide) for comment.

Overview of the draft guide

The draft guide sets out an overview of a typical franchise arrangement in relation to which the views on the document would pertain. This arrangement involve that the franchisor would provide the franchisee with branding, a distribution mechanism, uniform product specifications and services. Such an arrangement would therefore include that the franchisor provide the franchisee with both the right to use intellectual property but also the knowledge of business processes.

The draft guide starts of by stating, and confirming, that no specific provisions relating to franchise arrangements exist in the Income Tax Act (Act). The tax treatment of such arrangements should therefore be determined with reference to the definition of gross income in section 1(1) of the Act and the general deduction formula in section 11*(a)* read with section 23 of the Act. The focus of the draft guide is to provide the SARS view on the application of these requirements to the various elements of a franchise arrangement from the perspective of both the franchisor and franchisee. This article considers the view on the franchisee tax treatment of costs incurred.

Views on costs incurred by the franchisee

Recurring operating expenditure would generally be deductible under section 11*(a)* of the Act. As such, royalties and monthly service costs incurred by a franchisee in terms of a franchise arrangement should normally be deductible. This view was confirmed in the judgment of *BP Southern Africa (Pty) Ltd v C:SARS*, even though taxpayers got a scare in the tax court judgment on the matter. SARS states in the draft guide that royalties should generally not be of a capital nature and therefore deductible, even though this may still depend on the terms of the agreement and whether the income-earning structure of the franchisee is built up by the recurring costs. It is my view that the draft guide confirms that the nature of these costs is probably not as contentious as before the BP case, but may not always be clear-cut.

The more contentious aspect relates to the initial fees to be paid by the franchisee. The draft guide distinguishes between license fees and initial fees. The draft guide commences in this regard by stating that both categories of expenses would normally contribute towards the creation of the infrastructure within which the franchisee will operate its business and would therefore be of a capital nature. As such, it is not deductible under section 11*(a)* of the Act.

The license fees generally establish the right to use licensed items, rather than the actual use of something. Section 11*(gD)* allows a deduction for certain license fees but these fees must be paid to the national, provincial or local government to qualify for deduction under that section. Franchise license fees are unlikely to fall into this category. The draft guide does not consider the application of section 11*(f)* of the Act to license fees.

The draft guide considers the possibility that the initial fee may be deductible under section 11*(f)* of the Act. This section allows a deduction under certain circumstances in respect of "any premium or consideration in the nature of a premium paid by a taxpayer for—… 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". SARS states their view that the initial fee would generally relate to a myriad of goods and services to be supplied by the franchisor to the franchisee and as such would not constitute a premium for the right to use intellectual property. This view is presumably based on the view that it may include payment for the right to use intellectual property, but not solely for this.

The view is also expressed in the draft guide that franchise agreements that do not make provision for initial fees, but rather for increased recurring fees, such as increased royalties, may be at risk of at least a portion of the costs being viewed as relating to the capital structure of the franchisee's business (similar to the initial fee). Should this be the case, I am of the view that taxpayers who are franchisees may struggle to fulfil the burden of proving the extent to which the fees incurred do not relate to the capital infrastructure created by the franchise arrangement.

Concluding thoughts

Taxpayers who are involved in franchise arrangements should study the views of SARS in detail and consider whether the terms of their specific arrangement are sufficiently addressed. This document remains open for comment until 12 February 2016.

Third party returns: New public notice issued

Section 26 of the Tax Administration Act (TAA) makes provision for certain persons to be required to submit returns with information about third parties. The Commissioner is required to set out the requirements in a public notice. A number of such public notices have been issued in relation to section 26 over the past few years. A new public notice that replaces two earlier notices (Notice 260 and Notice 420 issued during 2013) was issued on 9 January 2016. The content of the new notice does not appear to be significantly different from the earlier ones, except for a few additions. The requirements of the new notice (Notice 1 of 2016)[1] are however summarised, with some commentary on various aspects of it, in this article seeing that many taxpayers still have question or may not be aware of their obligation to submit third party information.

Timing of submission

The persons listed in the notice should submit returns for the following periods:

- 1 March to 31 August (return submitted by 31 October); and
- 1 March to end of February (return submitted by 31 May).

An alternative period may be agreed with the Commissioner.

Persons who are required to submit third party returns

An **IT3(b)** that reflects the amounts paid, due and payable or received by way of an investment, rental of immovable property, interest or royalty or amounts recorded in accounts maintained for another person as well as any tax withheld should be submitted by:

- Banks, Co-operative banks, the South African Postbank
- Financial institutions regulated by the executive officer, deputy executive officer or board as defined in the Financial Services Board Act;
- Listed companies, State-owned companies or organs of state in respect of bonds, debentures or similar instruments;
- Estate agents and practising attorneys who pay or receive amounts in respect of investments, interest or rental of property on behalf of a third party
- Persons liable to withhold the withholding tax on interest (WHTI) in terms of section 50F(2) of the Income Tax Act (*this is a new addition to the list*).

The following persons must submit an **IT3(c)** reflecting all amounts paid in respect of the purchase and disposal of financial instruments:

- Banks, Co-operative banks, the South African Postbank
- Financial institutions regulated by the executive officer, deputy executive officer or board as defined in the Financial Services Board Act; and
- Listed companies, State-owned companies or organs of state in respect of bonds, debentures or similar instruments.

In addition, Financial institutions regulated by the executive officer, deputy executive officer or board as defined in the Financial Services Board Act may be required to submit an **IT3(f)** that reflects the purchases of and contributions made in respect of any retirement annuity policy as well as payments made in terms of insurance policies upon the death of a person.

Any person who purchases livestock, produce, timber, ore, minerals or precious stones from the primary producer, other than on a retail basis, needs to submit an **IT3(e)** that reflects monies paid for the purchase, sale or shipment of the relevant commodity (including by way of a bonus).

Medical schemes are required to submit an **IT3(f)** return reflecting contributions by persons to their medical schemes and medical expenses paid for a person by the scheme.

Lastly, also a new addition to the list, persons who issue tax-free financial instruments or policies, as contemplated in section 12T of the Income Tax Act, must submit an IT3(s) return that reflects contributions, withdrawals and transfers to and from tax free investments as well as any other amounts received or accrued in respect of such an investment.

Effect of non-compliance

Despite the submission of third party returns not yet being listed as an obligation where the non-compliance results in fixed amount administrative penalties, a person who wilfully and without just cause fails to submit a return as required under the TAA may be guilty of an offence in terms of section 234*(d)* of the TAA.

[1] Can be downloaded at: http://www.sars.gov.za/AllDocs/LegalDoclib/SecLegis/LAPD-LSec-TAdm-PN-2016-01%20-%20Notice%201%20GG%2039575%206%20January%202016.pdf

BPR 210: Issues arising from successive transactions and the treatment of debt in a rollover context

Many restructuring transactions require numerous steps to be executed in a sequence of transactions to achieve the desired economic outcome. In addition, one is likely to find liabilities of some sort being part of such transactions, especially where simplification of a structure is the aim. Binding Private Ruling (BPR210) deals with restructuring transactions with the ultimate purpose to shift operations spread across three entities to a single one.

Background facts

The transaction described in the ruling document is essentially one to simplify the operations of a group of related companies. It involves three parties, the Applicant and Co-applicant as well as a subsidiary of the Applicant. The first step in the transaction is for the subsidiary of the Applicant to distribute all its assets to the Applicant as a liquidation distribution. Following this, the Applicant will transfer all its assets, including those acquired from the subsidiary in the liquidation distribution, to the Co-Applicant to execute a merger under section 113 of the Companies Act. As part of the merger, the Co-Applicant will assume certain debts from the Applicant, including intra-group debts (which will effectively be extinguished) and contingent liabilities. The ruling confirms comprehensively that the proposed transactions meet the requirements of, firstly, section 47 of the Income Tax Act (Act) for the liquidation distribution and, secondly, section 44 of the Act for the amalgamation. This article focuses on the three grey areas where I am of the view that this ruling may provide useful guidance.

Successive rollover transactions

The potential issue with successive rollover transactions is well illustrated in the proposed transaction. The Applicant acquires the assets from its subsidiary in terms of the liquidation distribution. Amongst other, section 47(2)*(a)* of the Act provides relief in the following circumstances:

> "Where a **liquidating company disposes** of— (a) a **capital asset** in terms of a liquidation distribution to its **holding company which acquires it as a capital asset**…" (emphasis added)

A capital asset is defined in section 41(1) of the Act as an asset that does not constitute trading stock. Trading stock in turn is defined in section 1 of the Act as amongst others anything acquired by a taxpayer to sale or exchange. The view may exist that the assets of the subsidiary were acquired by the Applicant with a view and purpose to exchange for Co-Applicant shares in the subsequent merger and would be trading stock as such. The ruling confirms that section 47(2)(a) relief is available and therefore that these assets are not viewed as trading stock in the manner contemplated above. This view is arguably based on the fact that the definitions in the Act should be considered in a particular context. It is submitted in the context of roll-over afforded within an economic unit, one may need to consider the purpose of the asset in question from that economic unit's perspective in light of the restructuring's rationale.

Treatment of debt in rollover transactions

Two further contentious issued addressed in the ruling relate to the interpretation of the following requirement in section 44(4) that limits the relief afforded to assets disposed in exchange for shares in the resultant company or:

> "…the assumption by that resultant company of a **debt** of that amalgamated company…" (emphasis added)

The first important aspect of the ruling in this regard is that contingent liabilities (the ruling does not specify the nature) constitute debt for purposes of section 44(4). In the ordinary sense, the word debt is defined as something that is owed or that one party is bound to pay to the other. Strictly speaking, a contingent liability may become owing in future, but the obligation's existence is still uncertain while it is only a contingent liability. The SARS view of a contingent liability as debt for rollover purposes is in line with the draft interpretation note on the treatment of contingent liabilities, which also proposes a similar interpretation of 'debt' when rollover applies.

The second aspect of interest is that the ruling confirms that the assumption of a liability owing by the transferor to the transferee, which effectively extinguishes the debt, also qualifies as an assumption of debt as contemplated in section 44. In addition, no debt reduction that may trigger recoupments and base cost adjustments arises.

Concluding thoughts

The wording of the rollover provisions in the Act is highly technical and taxpayers need to be aware of the finer nuances of these provisions. I am however of the view that this ruling (and similar ones issued earlier) illustrates that one may need to take a view on interpretation that is not strictly focussed on the narrow meaning of the words but also takes into account the broader purpose of the rollover relief provisions. The uncertainty caused by the apparent conflict between the two statements above may well explain the number of recent rulings requested on the subject of application of the rollover relief rules.

BPR211: The interaction between section 24I and rollover relief

The focus of rollover relief is often on the transfer of assets in respect of which depreciation allowances were claimed to ensure that no recoupments or capital gains arise on such transfers. Binding Private Ruling 211 (BPR211) deals with a scenario where the subject of the relief is a foreign denominated loan to which section 24I of the Income Tax Act (Act) applies. This ruling illustrates the application of the rollover relief provision to such loans as well as some fundamental concepts of section 24I of the Act.

Background and proposed transaction

A company (hereafter referred to as the Applicant), which is a subsidiary of a listed company, advanced interest-bearing mezzanine loans to foreign related parties. As the loans do not have fixed repayment dates, section 24J was not applied. The provisions of section 24I(10) of the Act and more recently section 24I(10A) were however applied to defer the timing of when exchange gains or losses on the loans between connected persons were taken into account.

A subsidiary of the Applicant (hereafter referred to as SubCo) is being set up to perform a group treasury function and will provide funding to jurisdictions where the group is active. As such, the Applicant will transfer the loans (assets) to SubCo in exchange for shares in SubCo. Both the Applicant and SubCo have a long-term, and therefore capital, intention with the loans. It is anticipated that SubCo will realise the loans through repayment rather than disposal.

The main issue that the ruling deals with is essentially whether rollover treatment in respect of the deferred exchange gains and losses should be allowed.

Analysis of the ruling and relevant legislation

The ruling confirms that the transfer of the loans in exchange for the shares of SubCo will meet the definition of an asset for share transaction in section 42 of the Act. It goes on to state that the ruling exchange rate on the disposal date will be deemed to be the spot rate on the date on which the loan was advanced, resulting in no exchange gains or losses being taken into account on disposal. It also states that the exchange gains or losses should be deferred in the hands of SubCo while the requirements of section 24I(10A) are met. When this ceases to be the case, the exchange gain or loss should be determined with the spot rate at the date when the Applicant advanced the loan as the starting rate. As such, the full exchange gain or loss since the Applicant advanced the loan will eventually be taken into account in the hands of SubCo.

At first glance, it is not clear whether the treatment, which is effectively rollover relief, is afforded in terms of section 42 or section 24I or section 24I read together with section 42. As neither of the parties held the loan as trading stock, the loan would be a capital asset (also confirmed in the ruling). For purposes of section 42, an allowance asset is defined to include a capital asset in respect of which an allowance or deduction was allowed or a debt contemplated in section 11*(i)* or 11*(j)*. As it does not appear as if any bad debt or allowance for doubtful debt has been granted in respect of the loan, the loan would not meet the definition of an allowance asset. In relation to a capital asset, the transferor must be deemed to have disposed of it at its base cost in terms of section 42(2)*(a)*(i)*(aa)*. Base cost has its meaning in terms of the Eighth Schedule – in most circumstances, the expenditure incurred to acquire or create the asset. In the case of a loan, this would be the amount advanced to the counterparty. In the case of a foreign currency denominated loan, this would be the Rand amount translated at the exchange rate when the loan was advanced, as there is no specific inclusion for exchange gains into the base cost in paragraph 20 of the Eighth Schedule.

For purposes of section 24I, the term 'realised' (which is the trigger for an exchange gain or loss) includes both the settlement and disposal of a debt. At the realisation date, the ruling exchange rate in respect of debt is generally the spot rate on such date but where the consideration received on the disposal of the debt differs from such spot rate, this rate will be the 'disposal rate'. This term in turn is defined as the amount received in respect of the disposal of an exchange item divided by the foreign currency amount of the exchange item.

Based on the above analysis of the relevant provisions, it appears as if the approach followed to arrive at the view in the ruling would have been to apply section 42(2)*(a)* to conclude that the loan is deemed to be disposed of at its base cost. This base cost is still determined with reference to the exchange rate when the loan was advanced. For section 24I purposes, the exchange item is then not disposed at the ruling spot rate, but rather a disposal rate determined as the amount received (deemed to be the base cost – i.e. amount advanced – under section 42) divided by the foreign currency amount.

Concluding thoughts

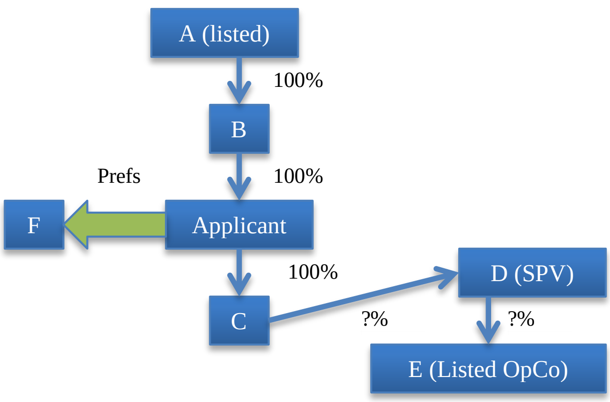
One often tends to only think of the effect of deemed amounts received under rollover relief in the context of capital gains and recoupments. This ruling is a good illustration that the effect of the rollover relief provisions is not limited to these two aspects of the Act. I may apply in other cases, for example, the disposal of debts and deferral of exchange gains or losses under section 24I.

BPR214: Funding and the impact of section 8EA

Binding Private Ruling 214 (BPR214) deals with the issue of redeemable preference shares and the risk that these instruments constitute hybrid type of instruments for tax purposes. Hybrid instrument treatment in the context of equity instruments can be as a result of the application of section 8E, which treats dividends received in respect of hybrid equity instruments to be income, or section 8EA, which has a similar effect where the instrument is a third-party backed share. This particular ruling deals with the application of section 8EA. Even though the ruling document does not necessarily provide a thorough overview of the commercial rationale for the specific restructuring and issue of the preference shares by the particular entity, it does arguably provide useful guidance and insight into the application of the provisions of section 8EA.

Background facts

The transaction in question involves a number of parties, only identified by alphabetic characters in the ruling. In short, the group and transaction flow can be depicted as follows:



Prior to the transaction, C borrowed an amount from B to purchase shares in D, a SPV incorporated to hold shares in E, a listed company. C subsequently delegated the debt owing to B to the Applicant (presumably C would then owe the Applicant an amount). The Applicant issued cumulative redeemable preference shares to a financier (F) and used the proceeds to partially settle the debt owing by it to B. Three classes of dividends are payable in respect of the shares. The Applicant indemnifies F by pledging and ceding certain rights to F. In addition, B subordinates its claims against the Applicant in favour of F. A guarantees all post-redemption obligations of the Applicant. Lastly, A and C may also extend guarantees to F in respect of non-payment by the Applicant. The ruling deals with the impact for purposes of section 8EA of the security provided by the other entities in respect of the Applicant's obligations.

Security arrangements

A third-party backed shares is defined as a preference share in respect of which an enforcement right is exercisable by the holder or an enforcement obligation is enforceable if certain payments are not made. An enforcement right is defined as a right that allows the holder to require another person to acquire the share from the holder, to make payment to the holder or to facilitate such acquisition or payment. An enforcement obligation is similarly defined as an obligation of a person other than the issuer to acquire the share from the holder or make such a payment as described above.

An important exception to section 8EA exists where the funds from the preference shares were used for a qualifying purpose. This includes the application of the funds for the direct or indirect purpose of acquiring an equity share in an operating company or the settlement by any person of a debt incurred for this purpose. If this is the case, section 8EA(3) states that enforcement rights and obligations that involve certain parties should not be considered in determining whether a share is a third-party backed share.

The first issue considered relates to the linkage between the funds obtained through the preference share issue and the acquisition by C of an interest in D, which acquired shares in an operating company, E. The ruling states that the funds obtained will be used for a qualifying purpose (settling a debt incurred directly or indirectly for the acquisition of equity shares by any person in an operating company). It is submitted that this ruling arguably considers an indirect link. From the ruling it appears as if the fact that the debt incurred for this purpose by C, which was subsequently delegated to the Applicant, did not lose its purpose when delegated. As with any ruling, it is only binding towards the applicant. In this particular case, the commercial motivation behind the delegation is not clear. It is however my view that the rationale for the delegation would be an important factor in determining whether the linkage to original purpose remains intact.

As the funds are used for a qualifying purpose, the enforcement rights that F may have against A and B must be disregarded. It is important that a qualifying purpose does not nullify all enforcement rights, but only those against persons listed in section 8EA(3)(b). In this instance, A and B form part of the same group of companies as the Applicant and would therefore meet the requirement to be disregarded in terms of section 8EA(3)*(b)*(iv). Guarantees and other security provided by third parties need to therefore be considered carefully to determine its impact on section 8EA's application, even if the funds obtained from the share issue are used for a qualifying purpose.

Back to the basics: The definition of a dividend

The concept of a dividend has largely been replaced with that of a distribution in the Companies Act of 2008. For tax purposes the term dividend is still defined in section 1 of the Income Tax Act and is of importance in a number of situations. This article analyses this definition and comments on some changes from the previous version of the definition and the Companies Act of 1973.

Importance of an amount being a dividend

From an income tax perspective, a dividend is generally not deductible by the company making the payment to a shareholder. As such, dividends are essentially paid from after-tax profits. In the hands of the shareholder, a dividend would be exempt from normal tax. This exemption is provided in section 10(1)*(k)*(i) of the Income Tax Act (Act). If the dividend is exempt from income tax, it may be subject to dividends tax. However, a number of exceptions exist, with a dividend being paid by a resident company to another being exempt probably being one of the most important (refer section 64F(1)(a)).

Dividends may arise in many contexts. In broad terms, one could perhaps categorise these circumstances between instances where the shareholder remains interested in the company and instances where the dividend forms part of the mechanism to extract value at the time when the shareholder ceases to be interested in a company. In the latter case, a dividend may fulfil a similar economic role as any other proceeds received on the disposal of shares. The tax implications of a dividend could however be significantly different from those of a disposal to unlock the value of the shares in another manner.

Definition of a dividend

Element 1: "any amount transferred or applied by a company that is a resident"

From this element of the definition it is clear that whenever value is transferred a dividend may arise. This transfer of value is not limited to a transfer in the form of cash, but anything that constitutes an amount. In the case of *C:SARS v Brummeria Renaissance (Pty) Ltd & Others* it was held that anything with a money value would constitute an amount. This first element is furthermore not linked to whether the amount in question is treated as a dividend for accounting purposes or not, or to the accounting reserve from which it is paid.

Element 2: "for the benefit or on behalf of any person in respect of any share in that company"

This is in my view the critical element of the definition that is often overlooked. The cause of the transfer of the amount should be a share in the company. If the real reason for the transfer is something else, for example, services rendered, this amount is not a dividend. Where planners suggest dividends that do not reflect the shareholding ratio, this may indicate that a portion of the payment received by the shareholder is not received by reason of shareholding. Making such distributions may also in some instances be contrary to the requirements of the Companies Act.

Element 3: "whether that amount is transferred or applied—
(a) by way of a distribution made by; or
(b) as consideration for the acquisition of any share in,

that company"

Value can be unlocked in the form of a distribution while the shareholder remains the owner of the shares (para (a)). However this same value may be distributed at the time of exiting the company in the form of a buy back price paid to the shareholder by the company (para (b)). The definition of a dividend includes both scenarios.

Element 4: "but does not include … amounts so transferred or applied … results in a reduction of contributed tax capital of the company…"

This element is intended to exclude a return of the initial capital contributed into the company. The concept of contributed tax capital (CTC) was introduced into the legislation in 2011 and other than the determination of the opening balance, is delinked from accounting balances.

Element 5: "but does not include … amounts so transferred or applied … results in a reduction of contributed tax capital of the company…"

The last exception considered here essentially relates to whether value has been extracted from the company to the shareholder yet or merely moved internally from one reserve to another while still remaining in the company. A distribution in shares achieves the latter and as such, does not constitute a dividend.

Further reading

The Comprehensive Guide to Dividends Tax issued by SARS provides a thorough discussion of the definition of a dividend in section 2.2.3. as well as the related concepts.

About PvdZ Consulting (Pty) Ltd

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