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Tax Implications of intellectual property transactions in South Africa

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University of the Witwatersrand, Johannesburg

A research report to be submitted to the Faculty of Commerce, Law and Management in partial fulfilment of the requirements for the degree of Master of Commerce (Specialising in Taxation)

Tax Implications of Intellectual Property Transactions in South Africa

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Degree: Master of Commerce (specialising in Taxation)

Final submission: January 2023

Abstract

Intellectual property law is a category of property that includes intangible creations of the human intellect, and primarily encompasses copyrights, patents, designs, trade marks and know-how.[1]

The intention of the use of intellectual property is important to determine the correct tax treatment to be assigned in the calculation of taxable income in a particular year of assessment.[2] The Income Tax Act 58 of 1962 ('Income Tax Act') is used, in this discussion, as a basis for determining the appropriate tax treatment of intellectual property transactions.

Extensive focus is placed on discussing the tax incentives of royalties, premiums, acquisition of intellectual property and internally generated intellectual property. It should be noted that one should consider case law and the specific circumstances of each case, to determine whether the amount related to intellectual property will be deductible in terms of s 11(a).[3]

An overview of the tax implications for a franchisor and a franchisee is depicted when both parties enter into a franchise agreement.

The taxation of image rights is specifically included in this discussion as companies, through their brands (i.e., trade marks) affiliate themselves with celebrities, sports professionals and influencers to drive their marketing strategy.[4]

A brief transfer pricing discussion regarding intellectual property is contained in the research report as it is imperative to determine whether an affected transaction has been entered into between connected persons which results in a tax benefit being derived.[5]

Keywords: Intellectual Property, South Africa, Income Tax Act 58 of 1962; Royalties; Copyright; Endorsements; Influencer; Trade Marks; Brands; Designs; Patents; Franchise; Transfer Pricing; Image Rights

[1] Giles, J., 2013, *'What is Intellectual Property or IP?'*, Michalsons, viewed on 23 June 2022, available from https://www.michalsons.com/blog/what-makes-up-intellectual-property/1170 at para.1

[2] *BP Southern Africa (Pty) Ltd v C:SARS*, 2007 SCA 7 (RSA) 69 SATC 79

[3] *BP Southern Africa (Pty) Ltd v C:SARS*, 2007 SCA 7 (RSA) 69 SATC 79

[4] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.556 and 565

[5] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2111; ans s 31 of the ITA

Declaration

I declare that this research report was drafted by myself with the assistance of my supervisor. I acknowledged other authors' work which were referred to in the report. I did not copy other students' work.

Name: Phindulo Sinobolo

Final submission: January 2023

Signature:

Acknowledgements

I would like to thank the Almighty for making this dream become a reality. To God be the glory.

To my loving parents (Sarah and Ephraim Sinobolo): thank you for your support and the advice you gave me which carried me throughout the process of writing the research report.

To my support system: thank you for being there when I needed encouragement. I am truly blessed to be surrounded by love.

I thank Mr Reinhard Rudd and Professor Alwyn De Koker for their expertise which contributed to the success of this research report.

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Chapter 1: Introduction to the research report

1.1 Introduction

The World Intellectual Property Organization (WIPO) defines 'intellectual property' as the ideas that one creates which can be used in the arts and trade.[6] These ideas include images, designs, symbols and 'artistic works'.[7] The use of intellectual property is imperative in a large number of companies' operations which adds to the enhancement of the South African economy.[8] For example, an invention, once it has met certain requirements, can be patented and used to improve business operations. A licensing agreement can contain the conditions for use of a trade mark, design, copyright and/or patent.[9] Franchising is a type of business model wherein permission to utilise the franchisor's intellectual property is granted to the franchisee[10] and therefore it will be worth discussing its tax implications.

The importance of the research is to raise awareness of the taxation and tax incentives for transactions related to intellectual property. The significance of the reliance on case law in determining the deductibility of an expense related to intellectual property is highlighted as case law gives guidance on the factors that should be considered. The discussion of the taxation of the compensation related to image rights is crucial as businesses have incorporated brand affiliation with sports professionals, influencers and celebrities in the promotion of their goods and services.[11]

An unconventional way of marketing is the use of social media and influencers. Influencers are celebrities and normal citizens who affiliate themselves with certain companies' brands by endorsing their quality products or services.[12] This marketing strategy is used to attract potential customers to the company and also makes the company's brand relatable among

[6] World Intellectual Property Organization, n.d., *'What is Intellectual Property?'*, World Intellectual Property Organization, viewed on 24 September 2020, available from https://www.wipo.int/about-ip/en/#:~:text=Intellectual%20property%20(IP)%20refers%20to,and%20images%20used%20in%20commerce. in para.1

[7] World Intellectual Property Organization, n.d., '*What is Intellectual Property?'*, World Intellectual Property Organization, viewed on 24 September 2020, available from https://www.wipo.int/about-ip/en/#:~:text=Intellectual%20property%20(IP)%20refers%20to,and%20images%20used%20in%20commerce. in para.1

[8] Geyer,S., Kelbrick, R.A, Klopper, H.B., Koornhof, P.G.J., Pistorius, T., Sutherland, P.J., Tong, L-A, van der Merwe, A.P.S. & de W van der Spuy, P., 2016, *Law of Intellectual Property in South Africa*, 2nd edn., LexisNexis, Durban. on pg. 363

[9] Alikhan, S., & Mashelkar, R., 2009, *Intellectual Property and Competitive Strategies in the 21st Century*, Wolters Kluwer, Netherlands on pg. 54

[10] Alikhan, S., & Mashelkar, R., 2009, *Intellectual Property and Competitive Strategies in the 21st Century*, Wolters Kluwer, Netherlands on pg. 54

[11] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.556

[12] Chen, J., 2020, '*What is influencer marketing: How to develop your strategy'*, Sproutsocial, viewed 18 January 2022, available from https://sproutsocial.com/insights/influencer-marketing/ in para. 5

existing customers.[13] We are currently living in an era where technological developments are occurring expeditiously.[14] The more innovative the invention is, the more valuable it becomes as it enhances business operations.[15] In turn, intangible assets influence the generation of income.[16]

An enquiry must be conducted regarding how the value can be measured and how the South African Revenue Service ('SARS') can strengthen the taxation of the endorsement services that influencers offer to brands. Some brand affiliation agreements may restrict the number of companies with which the influencer or celebrity may be affiliated.[17] This warrants a discussion on whether a brand affiliation relationship that is created between the celebrities or influencers and the companies would result in the celebrity or influencer being seen as an employee or an independent contractor.

The use of intellectual property in cross-border transactions presents an opportunity for a discussion in determining how robust anti-avoidance provisions in South African tax legislation are.

This research report discusses the South African tax incentives for the creators of intellectual property and the taxation of the income that is derived from it.

1.2 Research question

The following question has therefore emerged which encompasses the focus of the research:

'How are intellectual property transactions taxed in South Africa?'

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[13] TaxSlayer Editorial Team, 2019, *'Filing Taxes for YouTubers, Bloggers, and Other Social Media Influencers'*, TaxSlayer, viewed on 30 April 2020, from https://www.taxslayer.com/blog/filing-taxes-for-youtubers-bloggers-and-other-social-media-influencers/ on para.1

[14] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.373

[15] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.373

[16] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.373

[17] Bones, B., n.d., '*3 Types of Brand Celebrity Endorsement Deals (+ Payment Options)'*, PR Couture, viewed on 27 April 2022, from https://www.prcouture.com/2017/11/celebrity-brand-endorsement-types/ on para.8

From the main research question, the following sub-questions arise:

- What is South Africa's tax regime as per the Income Tax Act, 58 of 1962 (hereafter 'ITA') on intellectual property from a domestic and cross-border perspective?
- What do the tax implications for franchise agreements entail?
- What is the South African tax treatment of image rights?
- Should influencers and celebrities with endorsement deals be treated as employees or independent contractors in an effort of ensuring tax compliance?

The report sheds some light on the tax treatment of the transactions that are related to intellectual property to create awareness for businesses. There is also a focus on the research and development activities that are used to enhance technological innovation that can be registered as patents.

There is a growing trend regarding the influencer-marketing culture which has had an impact on advertising.[18] The advertising and marketing are done through the use of brand association.[19] The research report explores the tax implications that arise throughout the relationships between businesses and the said influencers or celebrities who have endorsement deals with some businesses. The compliance aspect of tax is explored to determine whether there should be a directive process and/or PAYE deducted on the amount that was earned by the said influencer or celebrity. This is to ensure that some amount of tax is collected towards the revenue drive.

1.3 Scope and limitations

The research report is focused on the tax implication of intellectual property per the ITA. The sections that are the focus are the gross income definition (as contained in s1), s9, s11(a), s11(f), the previous s11(gA) (now replaced with s11(gC)), s11(gB), s11A, s11D, s23(g), s23B, s23I, s31, s 49A - 49H, the Fourth Schedule and the Eighth Schedule. Other legislations that are referred to in the research report are the Copyright Act, 98 of 1978; Designs Act, 195 of 1993; Patents Act, 57 of 1978 and Trade Marks Act, 194 of 1993 as they contain the definitions of copyright, design, patent and trade marks respectively. Case law is also referred to in this discussion.

[18] Tragotsi, A., 2020, *'How are social media influencers being taxed?'*, Spear's, viewed on 30 April 2020, from https://www.spearswms.com/how-are-social-media-influencers-being-taxed/ on para.7

[19] Tsele. L., 2018, *'Why The Influencer Marketing Trend Is Catching On In SA And The Names You Should Get To Know'*, SME South Africa, viewed on 30 April 2020, from https://smesouthafrica.co.za/influencer-marketing-trend-catching-sa-names-get-know/ on para.1-2

The sections of the Tax Administration Act[20] that are discussed in the research report are s 80 (which refers to instances where an advance ruling cannot be sought) and s 102 (which details the instances where the burden of proof will lie on the taxpayer as well as SARS).

Some aspects of the OECD Model Tax Convention (i.e., 'Permanent Establishment' (Article 5), 'Associated Enterprises' (Article 9), 'Royalties' (Article 12) and 'Capital Gains' (Article 13)) are discussed. This is because South Africa has an 'observer status'[21] with the OECD and some aspects of the tax legislation refer to concepts that have been defined in the OECD Model Tax Convention (e.g. the term 'permanent establishment' is included in s 1 of the ITA where reference to Article 5 of the OECD Model Tax Convention is made). The terms referred to in these articles are referred to in the South African ITA and therefore the reference made to these articles is to adequately explain the meaning of the terms from a South African and cross-border perspective. Only one OECD BEPS Action Plan (specifically Action 8 – 'Assure that transfer pricing outcomes are in line with value creation – Intangibles') will be referred to in this research report.

The aspects of intellectual property that are not discussed in detail are the plant breeder's rights; the competition aspect of intellectual property; the bare dominium intellectual property schemes; exchange control regulations; as well as indigenous and traditional knowledge. There is no focus on the Value Added Tax implications.

1.4 Research methodology

The research methodology adopted for this study is of a qualitative, interpretative nature with a focus on describing provisions in the South African Tax Acts which are relevant to intellectual property; and analysing and interpreting these provisions.

A detailed literature review is performed so that the basis and the direction of the discussion are established. The resources used for the report are books (hardcopy and e-books), journal articles (which were mainly found on the internet), case law, government and organisation publications, legislation and internet publications.

[20] 28 of 2011

[21] South African Department of International Relations & Cooperation, n.d., 'Organisation for Economic Cooperation and Development (OECD)', *South African Department of International Relations & Cooperation*, viewed on 24 September 2020, available from http://www.dirco.gov.za/foreign/Multilateral/inter/oecd.htm#:~:text=South%20Africa%20is%20not%20a,subsidiary%20bodies%20of%20the%20Organisation. in para.2

Chapter 2: The types of intellectual property

The definitions of the different types of intellectual property are discussed in this chapter. This is so that a background is established for the tax treatment discussion and also to establish to what the term 'intellectual property' refers.

The main types of intellectual property (i.e., copyright, trade mark, patent and design) are not defined in the ITA, however, they are defined in respective Acts that govern these types of intellectual property. The paragraphs below describe intellectual property in general terms as well as in the respective Acts.

Section 2 of the Copyright Act,[22] lists the works which can be copyrighted. A specific definition of the term 'copyright' is not provided under s 1 of the Copyright Act.[23] A copyright is defined by the Merriam-Webster dictionary as the access of artistic, literary, musical, etc. creations granted to one for distribution, publishing, reproducing or selling.[24] Copyright is a right that provides the legal conservation and protection of works created by composers, artists and authors to ensure that they will be compensated for any use of their works.[25] The copyright law's main objective is to provide the owner with control of how the work(s) will be used, thereby, preventing possible misuse.[26] It should be understood that the works of artists, authors and composers are the depictions of their ideas and, therefore, the ideas alone, cannot be protected.[27]

A trade mark is a symbol which is used to differentiate the services or goods that are offered by one business from others that are in the industry.[28] Trade marks have two functions namely: to differentiate the goods and services of one manufacturer or provider from the next; and the promotion of goods and services through advertising (which is a component of marketing).[29] The definition provided of a trade mark per the Trade Marks Act[30], states that it is a symbol which enables a person to differentiate his or her goods or services from the next business.[31]

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[22] 98 of 1978

[23] The definition of copyright denotes copyright which is discussed in the Act

[24] Merriam-Webster Online Disctionary, n.d., Copyright, viewed on 22 June 2022, available from https://www.merriam-webster.com/dictionary/copyright?src=search-dict-hed

[25] Jacob, R., Alexander QC, D. & Fisher, M., 2013, *Guidebook to Intellectual Property*, Hart Publishing Ltd, Oxford on pg.141

[26] Jacob, R., Alexander QC, D. & Fisher, M., 2013, *Guidebook to Intellectual Property*, Hart Publishing Ltd, Oxford on pg. 141-142

[27] Jacob, R., Alexander QC, D. & Fisher, M., 2013, *Guidebook to Intellectual Property*, Hart Publishing Ltd, Oxford on pg.142

[28] World Intellectual Property Organization, n.d., 'Trademarks', *World Intellectual Property Organisation*, viewed on 11 June 2022, from https://www.wipo.int/trademarks/en/ on para.1

[29] Geyer,S., Kelbrick, R.A, Klopper, H.B., Koornhof, P.G.J., Pistorius, T., Sutherland, P.J., Tong, L-A, van der Merwe, A.P.S. & de W van der Spuy, P., 2016, *Law of Intellectual Property in South Africa*, 2nd edn., LexisNexis, Durban. on pg. 103

[30] 194 of 1993

[31] Trade mark as defined in s 2 of the Trade Mark Act, 194 of 1993

A patent is defined as the protection of an invention which contributes to technological advances in any industry.[32] A patent is defined in the Patents Act[33] as a document which serves as the approval of the invention by the government.[34] The following is a list of creations or acts that cannot be patented particularly because of the "technical character" element that is missing:[35]

- computer programmes;
- mathematical formulae;
- processes that dictate how mental acts are executed;
- discoveries;
- exhibition of information;
- 'literary, dramatic, musical or artistic works and other aesthetic creations'; and
- scientific hypothesis.

Computer programmes can, however, be protected under the Copyright Act.

A design is defined as a sketch or a depiction of what the final product of a garment, building or object will look like and an explanation (if any) of how the product will be used.[36] A design is defined as either being 'a functional design' or 'an aesthetic design'.[37] The Designs Act[38] distinguishes between two types of designs namely the aesthetic design and the functional design.[39] An aesthetic design is a planned creation of an item which is solely done to look appealing to the eye.[40] A functional design is a planned creation whose purpose is to improve the functions of an item to make it easy to use.[41]

[32] Geyer,S., Kelbrick, R.A, Klopper, H.B., Koornhof, P.G.J., Pistorius, T., Sutherland, P.J., Tong, L-A, van der Merwe, A.P.S. & de W van der Spuy, P., 2016, *Law of Intellectual Property* in South Africa, 2nd edn., LexisNexis, Durban. on pg. 359

[33] 57 of 1978

[34] Definition of patent as contained in s 2 of the Patent Act, 57 of 1978

[35] Geyer,S., Kelbrick, R.A, Klopper, H.B., Koornhof, P.G.J., Pistorius, T., Sutherland, P.J., Tong, L-A, van der Merwe, A.P.S. & de W van der Spuy, P., 2016, *Law of Intellectual Property in South Africa*, 2nd edn., LexisNexis, Durban. on pg. 365 and section 25 of thr Patents Act, 57 of 1978

[36] Oxford Languages, n.d., 'Design', *Oxford languages*, viewed on 23 January 2021, available from https://www.google.com/search?q=design+meaning&rlz=1C1JZAP_enZA842ZA843&sxsrf=AOaemvJ7E0XChgS0R_Hm4T0vz__HL8kjtw%3A1642912199532&ei=x9nsYb7qH8zdgQaQ0ZfQDw&ved=0ahUKEwj-6bLwhMf1AhXMbsAKHZDoBfoQ4dUDCA4&uact=5&oq=design+meaning&gs_lcp=Cgdnd3Mtd2l6EAMyCQgjECcQRhD5ATIGCAAQBxAeMgUIABCRAjIGCAAQBxAeMgUIABCRAjIECAAQQzIGCAAQBxAeMgYIABAHEB4yBAgAEEMyBggAEAcQHjoHCAAQRxCwAzoHCAAQsAMQQzoSCAAQgAQQhwIQsQMQFBBGEPkBSgQIQRgASgQIRhgAUOQJWMAbYKUlaAJwAngAgAHNAogBqxCSAQUyLTMuNJgBAKABAcgBCsABAQ&sclient=gws-wiz

[37] As defined in s 1 of the Designs Act, 195 of 1993

[38] 195 of 1993

[39] Geyer,S., Kelbrick, R.A, Klopper, H.B., Koornhof, P.G.J., Pistorius, T., Sutherland, P.J., Tong, L-A, van der Merwe, A.P.S. & de W van der Spuy, P., 2016, *Law of Intellectual Property in South Africa*, 2nd edn., LexisNexis, Durban. on pg. 320

[40] Section 1(1) of the Designs Act, 195 of 1993

[41] Section 1(1) of Designs Act 195 of 1993

Goodwill comes as a result of the maintained and increased reputation of a company in a specific industry.[42] Know-how is defined in the Merriam-Webster Dictionary as the expertise and skill of executing a particular thing without disruptions.[43]

The Trade-Related Aspects of Intellectual Property Rights ('TRIPS') Agreement sets a basis of a 'standards agreement' which can be implemented by World Trade Organization (WTO) members when drafting laws that promote the conservation of intellectual property.[44] The TRIPS agreement aims to advance the conservation of 'intellectual property rights' in ways that encourage fair trade.[45] The TRIPS Agreement provides for the protection of trade marks; patents; designs (including the industrial designs and 'layout-designs of integrated circuits'); copyrights; 'undisclosed information' (such as test data and trade secrets); and geographical indications.[46]

An endorsement occurs when a person attests that a particular company is the best provider of a certain product or service and that they would vouch that more customers use the company's product or service.[47] Sometimes, endorsements merely involve a celebrity or an influencer promoting the company's product or service by using them consistently to communicate that the company is an expert supplier for certain things such as sporting clothes or skin care products (amongst many other items).[48] The source of the endorsement relationship is an agreement that is drawn between the company and the celebrity or influencer

[42] Jacob, R., Alexander QC, D. & Fisher, M., 2013, *Guidebook to Intellectual Property*, Hart Publishing Ltd, Oxford on pg.77

[43] Merriam-Webster Online Disctionary, n.d., Know-how, viewed on 22 June 2022, available from https://www.merriam-webster.com/dictionary/copyright?src=search-dict-hed

[44] World Trade Organization, n.d., *'Overview: the TRIPS Agreement'*, World Trade Organization, viewed 30 January 2022, available from https://www.wto.org/english/tratop_e/trips_e/intel2_e.htm#:~:text=The%20TRIPS%20Agreement%20is%20a,own%20legal%20system%20and%20practice. in para. 4

[45] World Trade Organisation, 2005, *Agreement on Trade-Related Aspects of Intellectual Property Rights as Amended by the 2005 Protocol Amending the TRIPS Agreement*, World Trade Organisation, viewed 21 November 2021, from https://www.wto.org/english/docs_e/legal_e/trips_e.htm#part2_sec6 on pg.2

[46] World Trade Organization, n.d., '*Overview: the TRIPS Agreement'*, World Trade Organization, viewed 30 January 2022, available from https://www.wto.org/english/tratop_e/trips_e/intel2_e.htm#:~:text=The%20TRIPS%20Agreement%20is%20a,own%20legal%20system%20and%20practice. in para. 1

[47] Tandem, 2019, *'Sponsorship vs. Endorsement Deals'*, Tandem, viewed on 27 April 2022, from https://tandempartnerships.com/sponsorship-endorsement/#:~:text=Sponsorship%20agencies%20reach%20out%20to,endorsement%20deals%20come%20into%20play. at para.2

[48] Tandem, 2019, *'Sponsorship vs. Endorsement Deals'*, Tandem, viewed on 27 April 2022, from https://tandempartnerships.com/sponsorship-endorsement/#:~:text=Sponsorship%20agencies%20reach%20out%20to,endorsement%20deals%20come%20into%20play. at para.4

where the company will be granted permission for the use of the celebrity's or influencer's image rights.[49]

There are three types of endorsement deals which celebrities or influencers may be contracted to do:

'Once-off celebrity deals': this is when a celebrity or influencer is contracted to promote a company's brand on a once-off basis, either through an event appearance or a mention of the company's product or service on social media.[50]

'Unofficial deals': this is where a celebrity or an influencer receives a service or product for free from the company with the hope that the company's name will be marketed through social media or word of mouth.[51]

'Long-term celebrity deals': This involves the company associating itself with a celebrity or an influencer on a long-term basis in the hopes of ensuring that the authentic relationship created will assist in the company sustaining the market share.[52]

With the realisation that image rights can derive a large commercial value, some sports professionals and celebrities have resorted to setting up companies which manage the use of their image rights for economic gain.[53] This is done so that the sports professional does not bear the tax brunt and instead the amounts received from the commercialisation of the image rights will be included in the company's income.[54] The sports professional will access the commercial gain from the exploitation of their image rights through the after-tax dividends that will be distributed by this company.[55] What seems uncertain is whether SARS will permit such a scheme to be set up in South Africa.[56]

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[49] Ask for Ideas, 2022, *Are endorsements the same as sponsorship? check this out – difference between sponsorship and endorsement*, Ask for Ideas, viewed on 27 April 2022, from https://www.askforidea.com/are-endorsements-the-same-as-sponsorship-check-this-out-difference-between-sponsorship-and-endorsement/ at para.7

[50] Bones, B., n.d., '*3 Types of Brand Celebrity Endorsement Deals (+ Payment Options)'*, PR Couture, viewed on 27 April 2022, from https://www.prcouture.com/2017/11/celebrity-brand-endorsement-types/ on para.4

[51] Bones, B., n.d., '*3 Types of Brand Celebrity Endorsement Deals (+ Payment Options)'*, PR Couture, viewed on 27 April 2022, from https://www.prcouture.com/2017/11/celebrity-brand-endorsement-types/ on para.6

[52] Bones, B., n.d., '*3 Types of Brand Celebrity Endorsement Deals (+ Payment Options)'*, PR Couture, viewed on 27 April 2022, from https://www.prcouture.com/2017/11/celebrity-brand-endorsement-types/ on para.8

[53] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.559

[54] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.559

[55] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.559

[56] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.559

2.1 Conclusion

The purpose of the discussion above was to analyse the elements of intellectual property so that an enhanced understanding of the term is formed.

Chapter 3: South African taxation of intellectual property

The purpose of the chapter is to illustrate how the South African tax implications of the creation, purchase and granting of intellectual property are set out.

The use or granting of access to intellectual property is included in the definition of trade in s 1 of the ITA.[57] As such, the tax treatment of the use and grant of use of intellectual property is analysed.

3.1 Income aspect of intellectual property

South Africa's tax regime is based on residence and this means that the income earned by a resident, irrespective of its source, is taxed in the resident's hands.[58] The residence-based tax system in South Africa was effective from 1 March 2001.[59] 'Ordinarily resident' or the physical presence test is used to determine whether an individual (i.e., a natural person) is a South African resident.[60] A person who is not a natural person can be considered a resident if it has been 'incorporated, established or formed' in South Africa.[61] Should that not be the case, it should then be determined whether the person's 'place of effective management' is in South Africa.[62]

A taxpayer may receive compensation for granting the use of its intellectual property to another taxpayer or person. The amount received or accrued may be subject to being included in gross

[57] As contained in section 1 of the ITA

[58] South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.57

[59] South African Revenue Service, 2022, *'Cease to be a Resident'*, South African Revenue Service, viewed on 29 March 2022, available from https://www.sars.gov.za/individuals/cease-to-be-a-resident/#:~:text=From%201%20March%202001%2C%20South,a%20source%20within%20South%20Africa.on para.1

[60] Definition of residence in section 1 of the ITA **and** South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.57

[61] Definition of residence in section 1 of the ITA **and** South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.57

[62] Definition of residence in section 1 of the ITA **and** South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.57

income. The following elements of the gross income definition should therefore be considered:[63]

- total amount
- in cash or otherwise
- received by or accrued to
- during the year of assessment
- not of a capital nature

Royalties are amounts paid to a licensor, by agreement (usually contractual agreement), as compensation for the use of the licensor's intellectual property.[64] The royalty payments may be based on a rate or a flat fee and the parties to the agreement may decide on the frequency of the payments.[65] The royalty amounts received by a taxpayer for granting the use of a copyright, patent, trade mark or design will be included in its gross income for a year of assessment. This is because the royalty amount received represents the fruit i.e., the grant of use of the intellectual property (dependent on the contract) and will ensure that regular income is generated by the person who grants such use.[66]

The term "not of a capital nature" is contentious and as such the different elements of the term will have to be analysed. This is discussed in detail under chapter 5 of this research report. Further to that, chapter 8 discusses the elements of capital gains tax in instances where it has been established that the amount received is of a capital nature.

Paragraph (g)(iii) of the gross income definition specifically includes the amount received or accrued as a premium (initial fee) for the use of copyrights, patents, designs or trade marks in gross income. This means that the person who authorised the use of the intellectual property through a contractual agreement will be expected to include the premium in gross income even though the amount may be of a capital nature.[67] Paragraph (gA) of the gross income

[63] As contained in section 1 of the ITA

[64] Royalty Range, 2020, *'What is a royalty payment?'*, Royalty Range, viewed on 16 June 2022, available from https://www.royaltyrange.com/home/blog/what-is-a-royalty-payment#:~:text=A%20royalty%20payment%20is%20a,standard%20intellectual%20property%20licencing%20agreement. on para.2

[65] Royalty Range, 2020, *'What is a royalty payment?'*, Royalty Range, viewed on 16 June 2022, available from https://www.royaltyrange.com/home/blog/what-is-a-royalty-payment#:~:text=A%20royalty%20payment%20is%20a,standard%20intellectual%20property%20licencing%20agreement. on para.4-6

[66] Principle obtained from CIR v Visser 1937 TPD 77; 8 SATC 271

[67] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 109: Lease Premiums*, South African Revenue Service, South Africa, viewed on 16 June 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2019-02-IN-109-Lease-premiums.pdf on pg.5

definition relates to the amount that is received or accrued from the relaying of information, business acumen or scientific knowledge.

In terms of non-residents, the amount received or accrued from a South African source will have to be included in the gross income of the non-resident. Section 9 of the ITA stipulates the source rules on which the inclusion of gross income will be based. The specific subsections are as follows:

- s 9(2)(c) relates to a royalty paid by the South African resident
- s 9(2)(d) relates to a royalty paid regarding the use of s 23I intellectual property
- s 9(2)(e) relates to an amount paid to the non-resident for the relaying of information, business acumen and scientific knowledge. This knowledge will be used by a specific person.
- s 9(2)(f) relates to an amount paid to the non-resident for the relaying of information, business acumen and scientific knowledge that can be used by anyone in South Africa. This can occur when the non-resident has, for example, been invited to present at a function or workshop.

The amount that was included as gross income in terms of the gross income definition, as well as the source rules (as contained in s 9), may be exempt from income through s 10(1)(l) of the ITA if it is found that the individual non-resident was in South Africa for 183 days or less or the intellectual property (from which the royalty amount is earned) is not related to the operations of a permanent establishment which is operating in South Africa. The royalty amount will be subject to withholding taxes as per ss 49A – 49H of the ITA. The withholding taxes on royalties are discussed in chapter 6.

There is no extensive focus on the discussion of the 'receipt or accrual' of amounts for intellectual property as in most cases, the amount is accrued to the taxpayer as the taxpayer is embarking on trade to generate profit.[68]

[68] with reference to *CIR v Pick 'n Pay Employee Share Purchase Trust* 1992 (4) SA 39 AD

3.2 Expense aspect of intellectual property

Before the deductibility of any expense can be considered, the taxpayer should be 'carrying on a trade'.[69] 'Trade', as defined in s 1 of the ITA, is broadly defined and it includes the deployment or the accordance of intellectual property (i.e., design, copyright, patent, trade mark and any other similar property).[70]

3.2.1 Deductibility of expenses in terms of ss 11(a) and 23(g)

In order for an expense or a loss to be allowed as a deduction against income as defined[71], the following definition of the general deduction as contained in s 11(a) of the ITA should be met:

> 'For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived -
>
> (a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;'

The expense or loss that qualifies for a deduction must be fully expended for the purposes of trade and if not, the amount will be disallowed as a deduction.[72] The taxpayer's intention to deduct the expense incurred concerning intellectual property or the use thereof (as a result of a contract drawn between the taxpayer and the owner of the intellectual property) should be proved as per s 102(b) of the Tax Administration Act.[73]

The royalty payments may be of a revenue nature as the licensee is paying for the permission it obtained to use the intellectual property.[74] Should it be proven that the royalty payments form part of the business operations and the amounts incurred have a causal link to the overall

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[69] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.375

[70] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.376

[71] Section 1 of the ITA

[72] Section 23(g) of the ITA

[73] 28 of 2011. In addition, Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.374

[74] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.809

business purpose[75], the royalty payments may qualify for a deduction in terms of s 11(a) of the ITA.

Cases regarding the nature of amounts incurred related to intellectual property are discussed in chapter 5 below.

3.2.2 Acquisition or purchase of intellectual property

The acquisition or the purchase of intellectual property (excluding trademarks) can be considered for the allowance under s 11(gC) of the ITA.[76] This is for the purchase or acquisitions that took place on 1 January 2004 and dates after that date.[77] An allowance of 5% yearly, may be claimed on the intellectual property acquisition price (excluding designs).[78] For the acquisition prices for designs, a 10% allowance is permitted yearly.[79] The full allowance may be permitted where the acquisition price of intellectual property, excluding trade marks, is R5 000 and below.[80]

It is interesting to note that the preceding section, s 11(gA) of the ITA, permitted the partial deduction of the acquisition or the purchase of intellectual property, including trade marks (the allowance on the trademarks was terminated after 29 October 1999).[81] This means that the substantial difference between s 11(gA) and 11(gC) is the capital allowance regarding the acquisition of the trade marks.

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

[76] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.376

[77] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.376

[78] S&Z Attorneys, 2007, *'Claiming full allowances for acquisition of IP'*, S&Z Attorneys, viewed 16 June 2022, from https://snz.co.za/articles/taxation/claiming-full-allowances-for-acquisition-of-ip/ on para.1-3

[79] S&Z Attorneys, 2007, *'Claiming full allowances for acquisition of IP'*, S&Z Attorneys, viewed 16 June 2022, from https://snz.co.za/articles/taxation/claiming-full-allowances-for-acquisition-of-ip/ on para.1-3

[80] S&Z Attorneys, 2007, *'Claiming full allowances for acquisition of IP'*, S&Z Attorneys, viewed 16 June 2022, from https://snz.co.za/articles/taxation/claiming-full-allowances-for-acquisition-of-ip/ on para.5

[81] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.376

The main purpose of trade marks is to distinguish and promote goods and services.[82] Advertising and marketing expenses are incurred when a company wishes to promote its brand and trade mark in the market.[83] Advertising can take the form of sponsorship deals that companies may have with other entities.[84] Sponsorships can occur in the form of paying towards an event or donating money to a sporting club in exchange for the 'brand awareness'.[85] The aim of this is to derive a direct benefit which, in most cases, is free advertisement or promotion.[86] In terms of sporting clubs, the sponsorship can occur through a sporting brand which supplies sporting equipment and uniforms and the company's brand is shown on the sporting equipment and uniforms.[87] The success of a sponsorship relies on the relationship that is formed between a company/business and another party.[88]

The advertising and marketing expense is usually of a revenue nature as it is incurred for promoting a business which, in most cases, is fully operational.[89] It will be considered to be of a capital nature if there is an enduring benefit that is created (e.g. when a billboard is erected or signage has been placed outside a building).[90]

It was noted by SARS that there was a rise in the number of agreements whereby a business (considered to be a going concern) was sold and the trade mark (which was included in the

[82] Geyer,S., Kelbrick, R.A, Klopper, H.B., Koornhof, P.G.J., Pistorius, T., Sutherland, P.J., Tong, L-A, van der Merwe, A.P.S. & de W van der Spuy, P., 2016, *Law of Intellectual Property in South Africa*, 2nd edn., LexisNexis, Durban. on pg. 103

[83] Gerben Perrott PLLC, n.d., *'Trademarks and Advertising: What Do You Need to Know?'*, Gerben Perrott PLLC, viewed on 16 June 2022, available from https://www.gerbenlaw.com/blog/trademarks-and-advertising-what-do-you-need-to-know/ on para.19

[84] Tandem, 2019, *'Sponsorship vs. Endorsement Deals'*, Tandem, viewed on 27 April 2022, from https://tandempartnerships.com/sponsorship-endorsement/#:~:text=Sponsorship%20agencies%20reach%20out%20to,endorsement%20deals%20come%20into%20play. at para.3

[85] Tandem, 2019, *'Sponsorship vs. Endorsement Deals'*, Tandem, viewed on 27 April 2022, from https://tandempartnerships.com/sponsorship-endorsement/#:~:text=Sponsorship%20agencies%20reach%20out%20to,endorsement%20deals%20come%20into%20play. at para.1-2

[86] Ask for Ideas, 2022, *Are endorsements the same as sponsorship? check this out – difference between sponsorship and endorsement*, Ask for Ideas, viewed on 27 April 2022, from https://www.askforidea.com/are-endorsements-the-same-as-sponsorship-check-this-out-difference-between-sponsorship-and-endorsement/ at para.1

[87] Tandem, 2019, *'Sponsorship vs. Endorsement Deals'*, Tandem, viewed on 27 April 2022, from https://tandempartnerships.com/sponsorship-endorsement/#:~:text=Sponsorship%20agencies%20reach%20out%20to,endorsement%20deals%20come%20into%20play. at para.3

[88] Ask for Ideas, 2022, *Are endorsements the same as sponsorship? check this out – difference between sponsorship and endorsement*, Ask for Ideas, viewed on 27 April 2022, from https://www.askforidea.com/are-endorsements-the-same-as-sponsorship-check-this-out-difference-between-sponsorship-and-endorsement/ at para.3

[89] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.859

[90] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.859; *ITC 469* (1940) 11 SATC 261; **and** *ITC 217* (1931) 6 SATC 137

transaction) was highly priced.[91] The purchaser of the going concern would benefit from claiming the capital allowances and this would result in reduced income which would be subject to taxation.[92] Through the fact that the valuation of the trade marks is a laborious task to establish whether the trade mark in question was correctly valued, therefore proving that the deduction was adequate, SARS established that it would be best if capital allowance is not granted for trade marks.[93] The decision was made to protect the tax base.[94] It should, however, be understood that the revision of s 11(gA) of the ITA to exclude the capital allowance claim of trade marks which were acquired on or after 29 October 1999, and the exclusion of the acquisition of the trade marks from s 11(gC) of the ITA, does not mean that the trade mark expenditure will be lost. The expenditure may qualify as a base cost amount when it is disposed of through sale or ceded to someone else.[95]

A taxpayer should be aware that the initial fees and licence fees acquired cannot be considered for a possible allowance under s 11(gC) as the section relates to the actual intellectual property that was either created by the taxpayer or was purchased elsewhere.[96]

3.2.3 Intellectual property registration fees

The Companies and Intellectual Property Commission (CIPC) is an organisation where intellectual property must be registered in South Africa.[97] The registration fees (and the registration renewal thereof) for the intellectual property (specifically for designs, patents, trade marks) may be allowed as a deduction against income under the provisions as set out

[91] National Treasury, 1999, *Explanatory Memorandum on the Revenue Laws Amendment Bill, 1999,* National Treasury, South Africa, viewed on 22 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-1999-01-Explanatory-Memorandum-Revenue-Laws-Amendment-Bill-1999.pdf on pg.13

[92] National Treasury, 1999, *Explanatory Memorandum on the Revenue Laws Amendment Bill, 1999,* National Treasury, South Africa, viewed on 22 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-1999-01-Explanatory-Memorandum-Revenue-Laws-Amendment-Bill-1999.pdf on pg.13

[93] National Treasury, 1999, *Explanatory Memorandum on the Revenue Laws Amendment Bill, 1999,* National Treasury, South Africa, viewed on 22 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-1999-01-Explanatory-Memorandum-Revenue-Laws-Amendment-Bill-1999.pdf on pg.13

[94] National Treasury, 1999, *Explanatory Memorandum on the Revenue Laws Amendment Bill, 1999,* National Treasury, South Africa, viewed on 22 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/ExplMemo/LAPD-LPrep-EM-1999-01-Explanatory-Memorandum-Revenue-Laws-Amendment-Bill-1999.pdf on pg.13

[95] As per para. 11 and 20 of the Eighth Schedule of the ITA

[96] *ITC 1726* (64 SATC 236)

[97] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.378

in s 11(gB), provided that the taxpayer is 'carrying on a trade' and the expense is incurred 'in the production of income'.[98]

3.2.4 Licence fees and premiums

There are instances where the intellectual property is not created by the taxpayer, instead, the taxpayer would like to use the intellectual property which belongs to another person.[99] In this instance, there is an amount which has to be paid for the use of the intellectual property which will be viewed as compensation to the creator of the intellectual property.[100] This amount can be claimed as an allowance under s 11(f), as long as it can be proven that the amount was 'incurred in the production of income' and that the lessee has fulfilled the payment obligation.[101] The meaning of the word 'premium' has been detailed in the case of *CIR v Butcher Bros (Pty) Ltd*[102] to mean a payment which is made to a lessor by the lessee which is separate from the regular rental payments that will be made. The allowance should also be apportioned for the period in which the premium was used 'in the production of income'.[103]

The s 11(f) deduction will not be available where the lessee produces exempt income. If the lessee produces both the exempt income and income as defined, the deduction will be available against the income as defined, however, it should be apportioned appropriately.[104]

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[98] Dennehy, B., Bennett, A., Viljoen, G. & Kraamwinkel, C., 2020, *Corporate Tax,* Webber Wentzel, South Africa, viewed 16 June 2022, from https://www.webberwentzel.com/Documents/chambers-corporate-tax-guide-2020.pdf on pg.4-5

[99] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.378

[100] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.378

[101] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 109: Lease Premiums*, South African Revenue Service, South Africa, viewed on 16 June 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2019-02-IN-109-Lease-premiums.pdfon pg.11

[102] 1945 AD (13 SATC) 21

[103] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 109: Lease Premiums*, South African Revenue Service, South Africa, viewed on 16 June 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2019-02-IN-109-Lease-premiums.pdf on pg.12

[104] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 109: Lease Premiums*, South African Revenue Service, South Africa, viewed on 16 June 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2019-02-IN-109-Lease-premiums.pdf on pg.11

The allowance that can be claimed is the total amount that represents a premium which will be divided by the number of years that the premium will be valid for or 25 years.[105] The least amount of the deduction will be allowed against the income for the year.[106] The agreement between the licensor and the licensee may include the option to renew the licensing agreement, however, should the option be taken, the total period of the licensing agreement may not exceed 25 years.[107]

The s 11(f) allowance is also available in the instance where the taxpayer is required to pay a premium regarding the impartation of knowledge regarding intellectual property as well as providing support to the taxpayer requiring this assistance.[108] Should there be an agreement which encompasses the right of use of the intellectual property, as well as receiving guidance from the creator of the intellectual property, portions of the premium amount should be attributed to the premium related to the right of use of the intellectual property as well as the premium which will be related to the support (through the impartation of knowledge) which will be granted to the user.[109]

It should be noted that the s 11(f) allowance cannot be granted in an instance whereby the amount paid to the owner of the intellectual property is not considered as income in his hands.[110] This could be when it is established that the amount received does not originate in South Africa or that it is paid to a person that is exempt from tax, such as an institution that is listed in s 10 of the ITA.[111]

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[105] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 109: Lease Premiums*, South African Revenue Service, South Africa, viewed on 16 June 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2019-02-IN-109-Lease-premiums.pdf on pg.12

[106] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 109: Lease Premiums*, South Africa, viewed on 16 June 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2019-02-IN-109-Lease-premiums.pdf on pg.12

[107] Section 11(f) provisos (aa) and (cc) of the ITA; **and** De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg. 1111

[108] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 109: Lease Premiums*, South African Revenue Service, South Africa, viewed on 16 June 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2019-02-IN-109-Lease-premiums.pdfon pg.16 **and** s 11(f)(iv) of the ITA

[109] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.379

[110] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.379

[111] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from

Should there be an instance where the premium amount does not qualify as per s 11(f) of the ITA, this amount may be considered for a deduction under s 11(a).[112]

3.2.5. Internally generated intellectual property

A taxpayer can claim an allowance through s 11D which relates to the invention or creation of intellectual property.[113] The creation or invention of the intellectual property should be completed between 1 April 2012 and 1 April 2022 for the expenditure to be considered for a possible deduction under s 11D.[114] 'Research and development' means:

> 'systematic investigative or systematic experimental activities of which the results are uncertain'[115]

The research and development commence as a result of seeking to uncover a scientific factor that is not known yet (it could have existed but was considered ground-breaking because of its novel nature) or to create a computer programme, design or an invention (accompanied by the skill that was obtained through the invention or creation process).[116] This can be in the process of creating an invention that may be patented or a design as defined in the Patent Act[117] and Designs Act[118] respectively.

The proviso to the definition of 'research and development' as contained in s 11D(1), stipulates the activities which will not qualify for the s 11D allowance and they include goodwill, trade mark, administration, social science research and market research.[119]

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https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.379

[112] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 109: Lease Premiums*, South African Revenue Service, South Africa, viewed on 16 June 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2019-02-IN-109-Lease-premiums.pdf on pg.11

[113] South African Revenue Service, 2021, *'Research and Development Incentive'*, South African Revenue Service, viewed on 16 June 2022 available from https://www.sars.gov.za/businesses-and-employers/my-business-and-tax/research-and-development-incentive/#:~:text=Section%2011D%20allows%3A,or%20plant%20used%20for%20R%26D.on para.4

[114] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.377

[115] Section 11D(1) of the ITA

[116] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.1165; **and** South African Revenue Service, 2009, *South African Revenue Service – Interpretation Note 50: Deduction for Scientific or Technological Research and Development*, South African Revenue Service, South Africa, viewed on 19 April 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-50-Deduction-Scientific-Technological-Research-Development.pdf on pg.6

[117] 57 of 1978

[118] 195 of 1993

[119] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.1160-1161

Should it be found that the requirements have been met for the s 11D deduction, 100% of the deduction may be claimed in the year of assessment when the intellectual property (which qualifies for s 11D deduction) has been brought into use.[120] The taxpayer may also receive an additional 50% deduction if it is proved that the taxpayer (which is a company) incurred the expenditure in the process of conducting research and development or if the taxpayer is funding another taxpayer which is conducting the research and development.[121] The taxpayer which is funded by another taxpayer for conducting research and development should be an institution as listed in s 10(1)(cA), the Council for Scientific and Industrial Research (CSIR) or this company is considered to be of the 'same group of companies' as the company which offered it funding.[122] An additional requirement is that the extra 50% allowance had not yet been claimed.[123]

A taxpayer may receive a government grant to fund its research and development activities. This can include technological advancements and the creation of inventions for patenting. The government grant receipt is exempt from tax.[124] The expenses that have been incurred, which were funded (or partially funded) by the government grant, should be reduced by the government grant amount.[125] The allowance of 150% may be claimable on the remaining amount that was not funded by a government grant.[126]

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[120] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.377

[121] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.377

[122] du Raan, K., 2020, '*Why South African Businesses Should Apply for a Section 11D Tax Incentive Today.'*, Kisch IP, viewed on 16 June 2022, available from https://www.kisch-ip.com/article/why-south-african-businesses-should-apply-section-11d-tax-incentive-today on para.6

[123] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.377

[124] See s 10(1)(y) of the ITA

[125] See s 12P(6) of the ITA which relates to the reduction of the expense which is claimable under s 11. **Additional reference:** South African Revenue Service, 2009, *South African Revenue Service – Interpretation Note 50: Deduction for Scientific or Technological Research and Development*, South African Revenue Service, South Africa, viewed on 19 April 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-50-Deduction-Scientific-Technological-Research-Development.pdf on pg.27

[126] South African Revenue Service, 2009, *South African Revenue Service – Interpretation Note 50: Deduction for Scientific or Technological Research and Development*, South African Revenue Service, South Africa, viewed on 19 April 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-50-Deduction-Scientific-Technological-Research-Development.pdf on pg.27

The machinery that was acquired (between and including 1 April 2012 and 1 April 2022) for conducting research and development will qualify for a s 12C allowance.[127] If the machinery is new and unused, the accelerated allowance may be claimed (50% in the first year, 30% in the second year and 20% in the third year).[128] The allowance on the acquisition price of a building may be claimed at 5% a year if the building will be used for research and development activities.[129]

3.2.6 Pre-trade expenses – s 11A

A taxpayer may incur expenses before commencing trade.[130] The requirements, however, should be met for one to be eligible for the s 11A claim against income.[131]

One of the fundamental requirements that should be met is that the intellectual property (which fits the description above) should be used in South Africa as part of carrying on of a trade (even though the intellectual property may not have been created/invented and registered in South Africa).[132] It should be noted that the expenditure may be claimed under s 11A if the taxpayer incurred the expenditure related to the creation or invention of the intellectual property before trade commences.[133]

Section 11A of the ITA allows for a deduction of an amount which was incurred before the commencement of trade, provided that the amount would have qualified for a deduction under

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[127] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.378

[128] Proviso (d) to s 12C(1)

[129] S 13(1) of the Income Tax Act. In addition: Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.378

[130] Nel, P., 10 November 2020, *'[FAQ] Property financed by a taxpayer but registered in the spouse's name'*, The Tax Faculty, viewed on 16 June 2022, available from https://taxfaculty.ac.za/news/read/faq-property-financed-by-a-taxpayer-but-registered-in-the-spouse-s-name#:~:text=Section%2011A%20of%20the%20Income,is%20derived%20from%20the%20trade. on para.3

[131] Nel, P., 10 November 2020, *'[FAQ] Property financed by a taxpayer but registered in the spouse's name'*, The Tax Faculty, viewed on 16 June 2022, available from https://taxfaculty.ac.za/news/read/faq-property-financed-by-a-taxpayer-but-registered-in-the-spouse-s-name#:~:text=Section%2011A%20of%20the%20Income,is%20derived%20from%20the%20trade. on para.3

[132] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.377

[133] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.377 and s 11D(2)

ss 11, 11D or 24J. Regarding intellectual property, an amount could be allowed as a deduction under s 11A if the amount incurred would have qualified for a deduction under the following ss:[134]

- s 11(a) for the royalty payments made
- s 11(f) for the initial fees that were paid for the use of intellectual property or for paying the party who relayed the information, business acumen or scientific knowledge
- s 11(gB) which relates to the registration or renewal of trade mark, design or the grant/awarding of a patent
- s 11(gC) this relates to the acquiring of a patent, a design, a trade mark and a copyright
- s 11D for the amounts that were incurred for research and development which has been approved by the Minister of Science and Technology

3.3 Other issues for consideration

In terms of the compensation that is received as a consequence of the infringement of trade marks or copyright, the party that receives the compensation amount will have to determine the nature of the infringement and establish whether the amount is of a revenue or capital nature.[135] The party who caused the infringement will have to determine whether the compensation amount was incurred 'in the production of income' and whether the amount would be of a revenue or capital nature.[136]

3.4 Conclusion

The person who grants the 'right of use of intellectual property' will have to include the amount 'received or accrued' in his/its gross income.[137] The source rules should be relied upon for the inclusion of the amount in gross income where the person who granted the right of use is a non-resident.[138]

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[134] Sections as contained in the ITA

[135] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.16-18

[136] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.16-18

[137] Paragraph g(iii) of the gross income definition as contained in the ITA

[138] Source rules are contained in s 9 of the ITA

The person who has been granted access to utilise the intellectual property can deduct the royalty amounts under s 11(a) but only if it has been proven that the amounts are of a revenue nature.[139] Other sections that are available for the person to claim relief for the expense incurred regarding intellectual property include s 11(f) for the premium paid for the 'right of use of intellectual property'; s 11(gB) which relates to the registration of intellectual property; s 11(gC) regarding the acquisition for certain intellectual property; and s 11D for internally generated intellectual property for research and development.[140] Intellectual property expenses that were incurred before trade can be deductible under s 11A of the ITA if the requirements detailed in the section have been met.[141]

[139] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.809

[140] Sections contained in the ITA. Specific sections regarding intellectual property listed in the following source: Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y

[141] Nel, P., 10 November 2020, *'[FAQ] Property financed by a taxpayer but registered in the spouse's name'*, The Tax Faculty, viewed on 16 June 2022, available from https://taxfaculty.ac.za/news/read/faq-property-financed-by-a-taxpayer-but-registered-in-the-spouse-s-name#:~:text=Section%2011A%20of%20the%20Income,is%20derived%20from%20the%20trade. on para.3

Chapter 4: In-depth discussion of case law regarding intellectual property

This chapter contains a discussion of the case law regarding the deductibility of amounts paid for the right of use of intellectual property. The main discussion includes the factors which can be used to establish whether the amount is of a revenue or capital nature.

4.1 *New State Areas Ltd v CIR* 1946 AD 610 (14 SATC 155)

The court held that it should be determined whether the expense incurred forms part of or enhances the 'income-earning structure' or whether the amount incurred is related to the daily activities of the business.[142] The principle that has been established in this case applies in general in determining whether an expense is capital or revenue in nature. For intellectual property, it is important to determine the purpose of the amount incurred i.e. whether it adds value in creating an 'income-earning structure' or the expense is incurred for daily operations.[143]

4.2 *Commissioner, SARS v Kajadas Cosmetics (Pty) Ltd* 2002 (4) SA 709 (T) (64 SATC 200)

The taxpayer entered into an agreement which would permit it to distribute and sell an item in South Africa.[144] The agreement was for five years, thereafter the agreement would continue until circumstances arising, which were detailed in the agreement, would prevent the continuance of the agreement.[145] The licensor would be entitled to a yearly compensation.[146] It was determined that the amount created an 'income-earning structure' as, without the contract in place, the taxpayer would not be permitted to sell the product and therefore not earn an amount in return.[147] As such, the amount would therefore have to be treated as capital in nature.[148]

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[142] *New State Areas Ltd v CIR* 1946 AD 610 (14 SATC 155)

[143]Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.379

[144] *Commissioner, SARS v Kajadas Cosmetics (Pty) Ltd* 2002 (4) SA 709 (T) (64 SATC 200)

[145] *Commissioner, SARS v Kajadas Cosmetics (Pty) Ltd* 2002 (4) SA 709 (T) (64 SATC 200)

[146] *Commissioner, SARS v Kajadas Cosmetics (Pty) Ltd* 2002 (4) SA 709 (T) (64 SATC 200)

[147] *Commissioner, SARS v Kajadas Cosmetics (Pty) Ltd* 2002 (4) SA 709 (T) (64 SATC 200)

[148] *Commissioner, SARS v Kajadas Cosmetics (Pty) Ltd* 2002 (4) SA 709 (T) (64 SATC 200)

4.3 *ITC 1798* (68 SATC 9)

The taxpayer in question paid royalties as per the agreement it had with the licensor regarding a trademark licence.[149] The agreement stipulated that the trade marks could only be exploited in South Africa and that upon the termination of the agreement, the taxpayer would be revoked of the right to utilise the trade name (it used for its trade) as well as the licensed trade mark.[150] The taxpayer stated that the trade mark was owned by the parent company which was based in Britain and therefore the royalty payments made could not be regarded as creating an enduring benefit (as the agreement could dissolve after a 'six-month notice' was granted.[151] The following points were made by SARS:[152]

- The royalties enabled the taxpayer's business to improve as the trade marks offered amplified the brand of the taxpayer and this, in turn, secured the taxpayer's enduring benefit.[153]
- The trade mark licensing agreement gave the taxpayer the latitude for generating income.[154]
- The trade mark licensing agreement was entered into for the taxpayer to establish prominence in South Africa and therefore establish a strong customer base.[155]

The court maintained that the trade marks were imperative for the taxpayer to trade as the taxpayer's focus was to maintain its reputation as a global brand.[156] This was a strategy used to entice potential customers and maintain the customer base.[157] The court made a comparison to a 'landlord-tenant scenario' to depict that a tenant could continue its business even after it has moved to a different location.[158] This idea cannot be applied to trade marks in this instance, as the trade marks rented established the reputation of the taxpayer's business and influenced the creation of the South African customer base.[159]

The following points were noted to establish the taxpayer's intention of entering into a trade mark licensing agreement:[160]

[149] *ITC 1798* (68 SATC 9)
[150] *ITC 1798* (68 SATC 9)
[151] *ITC 1798* (68 SATC 9)
[152] *ITC 1798* (68 SATC 9)
[153] *ITC 1798* (68 SATC 9)
[154] *ITC 1798* (68 SATC 9)
[155] *ITC 1798* (68 SATC 9)
[156] *ITC 1798* (68 SATC 9)
[157] *ITC 1798* (68 SATC 9)
[158] *ITC 1798* (68 SATC 9)
[159] *ITC 1798* (68 SATC 9)
[160] *ITC* 1798 (68 SATC 9)

- Through the trade mark licensing agreement, the taxpayer did not have to incur hefty expenses through the rebranding of the business including the products provided.[161]
- The trade mark licensed provided a unique identity for the products which would easily be identified by the customers.[162]
- The brand was already known in the South African market which created a reputation for the business.[163]
- Attracting new customers would be manageable as the brand is well established in South Africa and this enabled the taxpayer to generate more income.[164]

It was mentioned in the case that the frequency of the royalty payments cannot be solely used to determine the nature of the expense.[165] It should also be noted that the method of calculating the royalty is a manner of establishing the amount and does not have a bearing on whether an amount is capital or otherwise.[166]

Reference was also made to *CIR v Genn & Co (Pty) Ltd*, [167] to emphasise that the nature of the amount incurred should be scrutinised to determine whether the amount constitutes the 'income earning' activities. It was further established that the mere labelling of an amount as a royalty payment should not be used as an indication that the amount is truly of a revenue nature.[168]

The intention for incurring the expenditure is crucial to determine whether the amount is capital or otherwise.[169] The following points were considered for the case:[170]

- A 'marketing indicia' licence was issued to the taxpayer which the taxpayer did not have an exclusive right for and could not assign to another person.[171]
- The ownership rights regarding the 'marketing indicia' and the licensed trade marks and the goodwill (created as a result of the taxpayer's use of the licence agreement), remain with the licensor.[172]

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[161] *ITC* 1798 (68 SATC 9)
[162] *ITC* 1798 (68 SATC 9)
[163] *ITC 1798* (68 SATC 9)
[164] *ITC 1798* (68 SATC 9)
[165] *ITC 1798* (68 SATC 9)
[166] *ITC 1798* (68 SATC 9)
[167] 1955 (3) SA 293 (A) (20 SATC 13)
[168] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.382 and *CIR v Genn & Co (Pty) Ltd*, 1955 (3) SA 293 (A) (20 SATC 13)
[169] *BP Southern Africa (Pty) Ltd v CSARS*, 2007 SCA 7 (RSA) (69 SATC 79)
[170] *BP Southern Africa (Pty) Ltd v CSARS*, 2007 SCA 7 (RSA) (69 SATC 79)
[171] *BP Southern Africa (Pty) Ltd v CSARS*, 2007 SCA 7 (RSA) (69 SATC 79)
[172] *BP Southern Africa (Pty) Ltd v CSARS*, 2007 SCA 7 (RSA) (69 SATC 79)

- The use of the 'licensed marks and indicia' will be prohibited once the licensing agreement comes to an end.[173]
- It was stipulated that the intellectual property ownership will not be transferred during the licence agreement period and the taxpayer was bound to make payments for the use of the intellectual property.[174]
- The intellectual property, during the licensing agreement, will not be improved.[175]
- The frequency of the royalty payments may have a bearing on whether an amount is capital in nature.[176]

The court had established that the royalty amounts incurred were aligned towards the income-generating activities and as such, the royalty amounts should be considered as revenue in nature.[177]

4.4 *ITC 11454* [2005] ZATC 17 (20 October 2005)

In the case of *ITC 11454,*[178] the taxpayer and its parent company (which is registered in England and Wales) drafted a contract regarding the licensing of trade marks. The contract was for two years, starting on 1 January 1997 and would be renewed every year.[179] The contract would dissolve should one of the parties grant the other a 'six-month notice' for the termination of the contract and/or the contract would end if one of the parties breached their duties as per the contract.[180]

The taxpayer was granted the right to use the trade marks and 'licensed marketing indicia' and the parent company was still the owner of the trade marks and the 'licensed marketing indicia'.[181] It was further determined that the trade marks and the 'licensed marketing indicia' would no longer be used by the taxpayer after the licensing agreement was terminated and the taxpayer would be able to continue trading under the name that was aligned to the trade marks and 'licensing marketing indicia'.[182]

The taxpayer was obliged to pay for the use of the trade marks and 'licensing marketing indicia' in a form of royalties.[183] The royalty amount to be paid by the taxpayer would have been

[173] *BP Southern Africa (Pty) Ltd v CSARS*, 2007 SCA 7 (RSA) (69 SATC 79)
[174] *BP Southern Africa (Pty) Ltd v CSARS*, 2007 SCA 7 (RSA) (69 SATC 79)
[175] *BP Southern Africa (Pty) Ltd v CSARS*, 2007 SCA 7 (RSA) (69 SATC 79)
[176] *BP Southern Africa (Pty) Ltd v CSARS*, 2007 SCA 7 (RSA) (69 SATC 79)
[177] *BP Southern Africa (Pty) Ltd v CSARS*, 2007 SCA 7 (RSA) (69 SATC 79)
[178] [2005] ZATC 17 (20 October 2005) at para.3 and 15
[179] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.15.1
[180] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.15.2
[181] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.15.3
[182] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.15.4 and para.16
[183] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.17

calculated as a percentage of items sold in the commercial/industrial, retail and other departments of the business.[184] The royalty amount was established based on the influence that the trade marks and the 'licensing marketing indicia' would have on the sales generated.[185] The royalty amount would not be established where the sales were generated based on availability and price.[186] The taxpayer held that its South African competitors were utilising the trade marks and 'licensing marketing indicia' which had an international presence.[187] The taxpayer established its presence in South Africa by using the parent company's trade marks and 'licensing marketing indicia'.[188]

The stance that the taxpayer had regarding the trade marks and 'licensing marketing indicia' was that its products would be identifiable.[189] The taxpayer created a market through the use of the trade marks and 'licensing marketing indicia' in South Africa.[190]

The trade marks and the 'licensing marketing indicia' offered to the taxpayer by the parent company allowed the taxpayer to maintain the reputation that has been created.[191] In addition to that, the established trade marks and 'licensing marketing indicia' assisted in maintaining the market already created for the taxpayer.[192] The enhancement of the trade marks and 'licensing marketing indicia' would then be used for attracting customers.[193] This will then lead to increased sales levels for the taxpayer.[194]

The taxpayer claimed royalties as deductions for the 1997, 1998 and 1999 tax years.[195] SARS disallowed the deduction claimed by the taxpayer.[196] The taxpayer, therefore, lodged an appeal for the deductions to be allowed.[197]

The facts of the case were scrutinised to determine whether the amount could qualify for a deduction under s 11(a) or whether the amount is of a capital nature.[198] The taxpayer maintained that the payment for the use of the trade marks and the 'licensed marketing indicia' was of a revenue nature.[199] The taxpayer stated that the parent company still owned the trade

[184] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.18
[185] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.18
[186] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.18
[187] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.21.1
[188] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.21.2
[189] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.21.2.1
[190] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.21.2.3
[191] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.21.2.4
[192] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.21.2.4
[193] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.21.2.4
[194] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.21.2.4
[195] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.24
[196] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.25
[197] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.25
[198] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.26
[199] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.28

marks and the 'licensed marketing indicia'.[200] The taxpayer also stated that the royalty amounts paid could not be considered capital in nature as the contract could be terminated once a party of the contract gives the other person a six-month notice.[201] The taxpayer also mentioned that there were amounts incurred annually so that the right of use of the trade marks and the 'licensed marketing indicia' could be used during operations.[202]

The taxpayer chose to use the parent's trade marks and the 'licensed marketing indicia' to maintain its customer base and draw new customers to the taxpayer's business.[203]

A trade mark is created to be unique so it can be easily identifiable and therefore its continuous use creates prominence within a market.[204] The use of the trade mark influences how the business is operated and creates a certain reputation for the business.[205] The end of the trade marks and the 'licensed marketing indicia' contract would mean that the taxpayer's operations would cease as the operations are dependent on the use of the trade marks and the 'licensed marketing indicia'.[206]

Through the reliance on the cases *Rand Mines (Mining & Services) Ltd v Commissioner for Inland Revenue*[207] and *U-Drive Franchise Systems (Pty) Ltd v Drive Yourself (Pty) Ltd and Another*[208], SARS determined that the trade mark and 'licensed marketing indicia' agreement formed a significant part of the 'income-earning structure' of the business[209] and that the trade mark and 'licensed marketing indicia' agreement is a form of support that was granted to the taxpayer by the parent company which would assist the taxpayer to generate income through the licensing agreement[210]. SARS also emphasised that, through the licensing agreement, the taxpayer was obliged to make payments which were set out in the agreement and if not, the taxpayer would have had the rights to use the trade marks and 'licensed marketing indicia' revoked.[211]

Waglay, J pointed out that licensing agreement enabled the taxpayer to generate high levels of income and it would be unlikely that the same levels of income would be produced should the licensing agreement be discontinued.[212] Waglay, J pointed out that the payments that were

[200] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.28.1
[201] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.28.2
[202] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.28.3
[203] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.30
[204] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.31
[205] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.31
[206] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.32
[207] 59 SATC 85 (1997 1 All SA 427 (A)
[208] 1976 (1) SA 137 (D)
[209] SARS' argument was made in relation to the principle laid out in *Rand Mines (Mining & Services) Ltd v Commissioner for Inland Revenue* 59 SATC 85 (1997 1 All SA 427 (A) on pg.94
[210] SARS' argument was made in relation to the principle laid out in *U-Drive Franchise Systems (Pty) Ltd v Drive Yourself (Pty) Ltd and Another* 1976 (1) SA 137 (D)
[211] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.41
[212] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.44

made concerning the use of the trade marks and 'licensed marketing indicia' should be considered to be 'capital in nature' as they are comparable to the amounts that are incurred when a business is created.[213] The licensing agreement should be viewed as an asset as the trade marks and 'licensed marketing indicia' form the basis of the taxpayer's operations.[214]

A principle stated in the *SIR v Cadac Engineering Works (Pty) Ltd*[215] case depicts that the expenses that have been incurred for the creation of a source of income for the business can easily be classified as a capital nature amount. It should be noted, however, for the amounts that are incurred on a day-to-day basis to maintain the income-earning ability of the business should be scrutinised further so that it can be determined that the amounts are truly of a revenue nature.[216] It should be noted further that the revenue and capital expenditure are used with the same objective which is to enhance the income generation capacity of the business, however, the nature of the expenditure should be ascertained to determine whether the expenditure is capital or otherwise.[217]

It should be noted that the licensing contract played a role in the taxpayer's business to ensure its success in the market.[218] With this, it can be argued that the licensing agreement between the taxpayer and the parent company created an asset and therefore the amount should be seen as capital in nature.[219]

Amounts that have been expended in purchasing or obtaining an asset could be of a capital nature.[220] Furthermore, if there are amounts that are incurred to circumvent being in direct competition with another business or company, those amounts are likely to be considered capital in nature.[221]

SARS presented its case to state that the success of the taxpayer's business relied on the licensing contract.[222] The fact that the licensing agreement which was drawn between the taxpayer and the parent company would continue for an indefinite period after the first two years (with a clause of a six months termination notice) suggests that the contract was permanent and as such, a capital asset was created.[223]

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[213] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.44
[214] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.45
[215] 27 SATC 61 1965 (2) SA 511 (A) at 63
[216] *SIR v Cadac Engineering Works (Pty) Ltd* 27 SATC 61 1965 (2) SA 511 (A) at 63
[217] *SIR v Cadac Engineering Works (Pty) Ltd* 27 SATC 61 1965 (2) SA 511 (A) at 63
[218] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.48
[219] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.48
[220] Principle established in the *CIR v African Oxygen Ltd* 1963 (1) SA 681 (A), 25 SATC 67
[221] Principle established in the *CIR v African Oxygen Ltd* 1963 (1) SA 681 (A), 25 SATC 67
[222] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.52
[223] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.52

It should be noted, however, that the duration of the expenditure cannot be the only determining factor regarding the nature of the expense.[224]

The taxpayer sought the licensing agreement as it gained access to using an internationally recognised brand name to maintain its competitiveness in the market as well as to benefit from the parent's goodwill which granted the taxpayer a well-established reputation.[225] Without the licensing agreement, the taxpayer would have had to establish its brand which could have taken a long time to build and it would have been uncertain whether the taxpayer would have been successful with its brand name.[226] Through the taxpayer entering the licensing agreement, it would have sustained the existing market share and attracted more customers to the business without having to establish a new identity as existing customers were familiar with the brand.[227]

The method of calculating the royalty payment cannot be used to determine whether the amount is capital or revenue in nature.[228] The method is only used to quantify the amount that is received.[229]

The licence agreement related to the trade marks and the 'licensed marketing indicia' can be likened to that of a trading licence acquired or a franchise agreement which is considered to be of a capital nature.[230] The licensing agreement enabled the taxpayer to operate its business through the use of the trade marks and the 'licensed marketing indicia' which were fundamental for the business operations.[231] It was established that the brand (in the form of the trade marks and the 'licensed marketing indicia') secured the market share and therefore the payments related to the licensing agreement were of a capital nature.[232] As such, the licensing payments could not be deducted in terms of s 11(a) of the ITA.[233]

[224] *CIR v VRD Investments (Pty) Ltd* 1993(4) SA 330 (C) at 378
[225] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.53.1 and 53.2
[226] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.53.3
[227] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.54
[228] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.58
[229] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.58
[230] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.61
[231] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.62
[232] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.64 and para.65
[233] *ITC 11454* [2005] ZATC 17 (20 October 2005) at para.65

4.5 *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A)

It was stated in the case that a link should be established between the expenses that are incurred and the continued activities.[234] In this instance, an amount related to intellectual property can only be allowed as an expense if it is related to business activities.[235]

4.6 *Hallstrom Pty Ltd v FCT* (1946) 3 AITR 436; 72 CLR 634)

It was established in this case that commercial considerations should be taken into account in determining whether an amount would be considered as capital or otherwise.[236] In this case, an intellectual property expense incurred should enhance the business operations, furthermore, can only be allowed as an expense of a revenue nature if it is related to the daily operating expenses.[237]

4.7 *Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd* [1964] 1 All ER 208(PC) at 212B–D ([1964] AC 948)

The terms 'capital structure' or 'enduring benefit' describes the type of expenditure that was incurred.[238] These descriptions are therefore scrutinised by the courts so it can be determined whether the treatment of the expenses could have been correctly applied.[239]

4.8 *CIR v George Forest Timber Co Ltd* 1924 AD 516

The principle obtained from *CIR v George Forest Timber Co Ltd*[240] is that amounts should be differentiated between money that purchases, creates or improves a 'source of profit'; and the amount which is incurred to maintain the 'source of profit'.

[234] *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A)
[235] *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A)
[236] *Hallstrom Pty Ltd v FCT* (1946) 3 AITR 436; 72 CLR 634) at 648
[237] *Hallstrom Pty Ltd v FCT* (1946) 3 AITR 436; 72 CLR 634) at 648
[238] *Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd* [1964] 1 All ER 208(PC) at 212B–D ([1964] AC 948 at 959)
[239] *Commissioner of Taxes v Nchanga Consolidated Copper Mines Ltd* [1964] 1 All ER 208(PC) at 212B–D ([1964] AC 948 at 959)
[240] 1924 AD 516

4.9 *CIR v Manganese Metal Co (Pty) Ltd* 1996 (3) SA 591

The court emphasised that there is no definite way of determining whether an amount could be of a revenue nature or a capital nature and this, therefore, warrants that the facts of each case should be weighed in pursuit of determining the right treatment of the amount.[241]

4.10 *British Insulated and Helsby Cables Ltd v Atherton AC* 205 All ER 623

The 'enduring benefit' test is utilised to determine whether an amount, when incurred, creates a lasting effect on the business and whether it is incurred for the betterment of the business.[242] This, therefore, means that the frequency of the payment is not as important as the effect that the amount has on the business to create the ability to generate income.[243]

4.11 *BP Southern Africa (Pty) Ltd v C:SARS*, 2007 SCA 7 (RSA) 69 SATC 79

BP Southern Africa was granted access to utilise the 'licensed marketing indicia'.[244] The agreement on hand was not exclusive and BP Southern Africa could not provide a sub-licence to another person.[245] BP, which was the parent company, was still recognised as the exclusive holder of the trade marks and the 'licensed marketing indicia'.[246] Any goodwill and additional privileges that arose from the contract would be accrued to the parent company.[247] The access to utilise the trade marks and the 'licensed marketing indicia' would be relinquished once the contract comes to an end.[248]

The royalty amount paid related to the 'right of use' of the trade mark and the 'licensed marketing indicia'.[249] The royalty amount was therefore compensation made to the parent company but did not create the right for BP Southern Africa to take ownership of the trade mark and the 'licensed marketing indicia'.[250] The royalty amount was paid to the parent

[241] *CIR v Manganese Metal Co (Pty) Ltd* 1996 (3) SA 591
[242] *British Insulated and Helsby Cables Ltd v Atherton* AC 205 All ER 623
[243] *British Insulated and Helsby Cables Ltd v Atherton* AC 205 All ER 623
[244] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*
[245] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*
[246] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*
[247] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*
[248] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*
[249] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*
[250] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*

company regularly and since no right of ownership was transferred to BP Southern Africa, the royalty amount was considered to be of a revenue nature.[251]

The Supreme Court of Appeal determined that the royalty payments which were made could be comparable to the rental payments that a taxpayer can make regularly and as such, the amounts incurred by BP Southern Africa were of a revenue nature.[252]

It is important to take into account the facts of each case to appropriately determine the treatment of the expenses that were incurred according to their nature.[253]

4.12 Conclusion

The courts' decisions in the case law above reveal that the facts and circumstances of any expense and licence agreement entered into should be scrutinised to determine whether the amount created an enduring benefit and whether an 'income earning structure' was created.[254] If the amount regarding intellectual property is incurred for the daily operational expenses, the amount may be deductible.[255] It is the taxpayer's responsibility to prove that an expense is rightfully claimed against income.[256]

[251] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*
[252] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*
[253] *BP Southern Africa (Pty) Ltd v C:SARS, 2007 SCA 7 (RSA) 69 SATC 79*
[254] *New State Areas Ltd v CIR* 1946 AD 610 (14 SATC 155)

[255] *BP Southern Africa (Pty) Ltd v C:SARS*, 2007 SCA 7 (RSA) 69 SATC 79

[256] Section 102(1)(b) of the Tax Administration Act, 28 of 2011

Chapter 5: Taxation of Franchise Agreements

A franchise is an agreement involving the provision of services and products by the franchisee through the licensing of the franchisor's trade marks and business model.[257] A franchisor is an entity or a person that grants another person (a franchisee) the licence to use its trade marks and other intellectual property as well as its assets in the course of the franchisor distributing its services and/or products.[258] A franchisee obtains the licence from the franchisor which represents the right to use the trade marks and operate under the guidance and control of the franchisor whilst benefitting from proven operating systems to ensure guaranteed returns.[259] A franchise agreement is a contract which is drawn between the franchisor and the franchisee which details the terms and conditions of licensing, support, control and operations.[260]

Once the agreement has been drawn between the franchisor and the franchisee, the initial fees should be paid by the franchisee which would serve as consent to be part of the franchise agreement with the franchisor.[261] Royalty fees will be paid by the franchisee during the franchise agreement and renewal fees will be paid in the case where both parties wish to renew the contract.[262] The franchisor will be responsible for executing its obligations as per the contract, including granting aid at the start of the franchise as well as continuing assistance

[257] International Franchise Association, n.d., *'What is a Franchise?'*, International Franchise Association, viewed 18 April 2022, available from https://www.franchise.org/faqs/basics/what-is-a-franchise at para.1 **and** South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.1

[258] International Franchise Association, n.d., *'What is a Franchisor?*', International Franchise Association, viewed on 18 April 2022, available from https://www.franchise.org/faqs/basics/what-is-a-franchisor at para.1; **and** South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.1

[259] International Franchise Association, n.d., *'What is a Franchisee?'*, International Franchise Association, viewed on 18 April 2022, available from https://www.franchise.org/faqs/basics/what-is-a-franchisee at para.1; **and** South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.1

[260] International Franchise Association, n.d., *'What are Common Franchising Terms and Definitions?'*, International Franchise Association, viewed on 18 April 2022, available from https://www.franchise.org/faqs/what-are-common-franchising-terms-and-definitions at para.5; **and** South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.1

[261] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.2

[262] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.2

to the franchisee.[263] The franchisee incurs the start-up costs of the franchise as well as the operational costs once the franchise is functioning.[264] It will be imperative for the franchisee to classify these costs correctly between costs that are of a revenue nature and those that are of a capital nature.[265]

The intellectual property of the franchisors will be registered first before they can be subject to franchise licensing agreements.[266]

In terms of the deductibility of the franchisor's intellectual property, the intention of the expense incurred would have to be determined.[267] The following is a list of activities that a franchisor would be involved in before a franchise could be set up:[268]

- acquiring a patent as well as the reinstatement or expansion of such;[269]
- develop the copyright, design or any other similar property;[270]
- formulating an invention;[271]
- trade name, trade mark or design registration;[272]
- trade name or trade mark registration renewal;[273] and

[263] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.2

[264] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.2

[265] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.4

[266] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.5-6

[267] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.3

[268] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.5-6

[269] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.5-6

[270] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.5-6

[271] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.5-6

[272] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.5-6

[273] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.5-6

- increasing the validity period of a design.[274]

These activities are done to establish an 'income-earning structure' and as such, are considered capital in nature.[275]

A licence fee, which enables the franchisee to operate and gain access to the franchisor's support, business process and intellectual property, will be considered a capital nature expense.[276] This is because the franchisor must pay this initial amount as part of setting up its franchise.[277]

In the case that the franchisee needs to make payment to the government (i.e., local, national or provincial government) for obtaining the operating licence for gambling, 'telecommunication services' or activities regarding petroleum products, the expense will be allowed as a deduction under s11(gD).[278]

A franchisee is expected to pay an 'initial franchise fee' which is seen as an amount which will allow for the use of the franchisor's intellectual property when the franchise is being set up.[279] Some of the other factors which are covered in the 'initial franchise fee' paid are:[280]

- site analysis;[281]

[274] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.5-6

[275] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.3

[276] Wallrich, n.d., *'The tax implications of a franchise arrangement: Franchise perspective'*, Wallrich, viewed on 28 May 2021, from http://www.wallrich.co.za/index.php/8-newsletter-articles/30-the-tax-implications-of-a-franchise-arrangement-franchise-perspective-2016 on para.5

[277] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.4

[278] Wallrich, n.d., *'The tax implications of a franchise arrangement: Franchise perspective'*, Wallrich, viewed on 28 May 2021, from http://www.wallrich.co.za/index.php/8-newsletter-articles/30-the-tax-implications-of-a-franchise-arrangement-franchise-perspective-2016 on para.5

[279] Wallrich, n.d., *'The tax implications of a franchise arrangement: Franchise perspective'*, Wallrich, viewed on 28 May 2021, from http://www.wallrich.co.za/index.php/8-newsletter-articles/30-the-tax-implications-of-a-franchise-arrangement-franchise-perspective-2016 on para.5

[280] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.5

[281] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.5

- staff training and recruitment;[282]
- drafting of contract;[283] and
- technical equipment.[284]

The following amounts for types of franchise agreements should be considered:[285]

- A 'start-up fee' which will confer the right to the taxpayer to operate in a certain area.[286]
- A 'start-up fee' which is related to the right of use of the intellectual property (which will still be owned by the franchisor.[287]
- The recurring fees which are incurred by the franchisee as compensation to the franchisor for the use of the intellectual property, as well as fees for operating in a particular area where the franchisor would have operated.[288]

The franchise fees differ, based on what has been agreed upon between the franchisor and the franchisee.[289] The initial fee paid to the franchisor should be included in the franchisor's gross income.[290] This is because the income is generated from the grant of the right to use

[282] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.5

[283] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.5

[284] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.5

[285] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.383

[286] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.383

[287] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.383

[288] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.383

[289] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.5

[290] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.6

the intellectual property to the franchisee(s).[291] Should it be found that the initial amount received as an 'initial franchise fee' is of a capital nature, the gross income definition still includes the amounts received regarding intellectual property[292] or the impartation of knowledge and skill regarding the intellectual property.[293]

The licence fee paid by the franchisee will be capital in nature as the amount is paid to secure the right of using the intellectual property, as well as be exposed to the well-established business structure.[294] The initial fee is paid for the right acquired for a franchisee to operate in a certain area.[295] What is important to note is that an 'initial franchise fee' that is paid by the franchisee may consist of various components of the obligations on which the franchisor will deliver.[296] This means that the full franchise fee cannot qualify for the s 11(f)(iii) deduction which only relates to the premium paid for the access to use the intellectual property.[297] It can be considered, however, whether the 'initial franchise fee' can be broken down to determine which part of the fee relates to the 'right of use of intellectual property'.[298] In this way, the section 11(f)(iii) deduction can then be limited to the 'right of use of intellectual property' amount of the entire 'initial franchise fee' that was paid.[299]

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[291] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.6

[292] Paragraph g of the gross income definition in s 1 of the Income Tax Act

[293] Paragraph gA of the gross income definition in s 1 of the Income Tax Act

[294] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.7; **and** Wallrich, n.d., *'The tax implications of a franchise arrangement: Franchise perspective'*, Wallrich, viewed on 28 May 2021, from http://www.wallrich.co.za/index.php/8-newsletter-articles/30-the-tax-implications-of-a-franchise-arrangement-franchise-perspective-2016 on para.5

[295] SAIT Technical, 2015, *'How do I treat the payment of a franchise fee for tax purposes?'*, SAIT, viewed om 27 May 2022, from https://www.thesait.org.za/news/227597/How-do-I-treat-the-payment-of-a-franchise-fee-for-tax-purposes-.htm on para.5

[296] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.7

[297] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.7

[298] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.7

[299] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.7

A franchisor and a franchisee can agree that the payment of a premium amount can be forfeited in place of an increased monthly amount that is payable by the franchisee.[300] As such, a calculation will therefore have to be made to determine which part of the monthly amount relates to the 'initial franchise fee' and it will be required that this amount be treated as capital in nature because of the purpose for which it was incurred (i.e., establishing an 'income-earning structure' for the franchise to operate efficiently).[301] It should be noted, however, that because the amount will be paid repetitively over some time, the portion which relates to the 'initial franchise fee' will not qualify for the s 11(f)(iii) as s 11(f)(iii) relates to an amount which is incurred for a premium which is paid once-off (and the deductions are spread over the franchise period or 25 years: the deduction granted will be the higher of the two amounts).[302]

In *CIR v George Forest Timber Company Ltd*[303], it was established that the amount incurred for establishing an 'income earning structure' should be considered capital in nature and the amount that is incurred for the daily operations of the business should be considered as revenue in nature. The determination of a capital nature amount cannot be limited to the fact that the amount is paid regularly: the intention or purpose of the amount should always be determined.[304] The *BP Southern Africa (Pty) Ltd v C:SARS* case[305], however, determined that the royalty payments which were made could be comparable to the rental payments that a taxpayer can make regularly and as such, the amounts incurred by BP Southern Africa were of a revenue nature. It is important to take into account the facts of each case to appropriately determine the treatment of the expenses that were incurred according to their nature. [306]

Included as part of the obligations of a franchisee in the franchise agreement are the royalty payments which are the compensation for the use of the franchisor's intellectual property.[307] These regular payments may be considered as capital in nature amounts because the

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[300] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.7

[301] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.7

[302] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.7 and s 11(f)(iii)

[303] 1924 AD 516, 1 SATC 20 at 26
[304] *New State Areas Ltd v CIR* 1946 AD 610, 14 SATC 155 at 170
[305] *BP Southern Africa (Pty) Ltd v C:SARS*, 2007 SCA 7 (RSA) 69 SATC 79
[306] *BP Southern Africa (Pty) Ltd v C:SARS*, 2007 SCA 7 (RSA) 69 SATC 79

[307] Wallrich, n.d., *'The tax implications of a franchise arrangement: Franchise perspective'*, Wallrich, viewed on 28 May 2021, from http://www.wallrich.co.za/index.php/8-newsletter-articles/30-the-tax-implications-of-a-franchise-arrangement-franchise-perspective-2016 on para.7

intellectual property forms a significant part of the franchise agreement.[308] It should be reiterated that the facts of each case should be taken into account to determine whether the tax treatment of the amount is in line with the purpose of the expenses incurred.[309]

For the franchisor, the determination should be made on whether the royalty amount is in consequence of offering the franchisee the right to use the intellectual property in its operations or whether there is some ownership that the franchisee may obtain in the intellectual property in question.[310] The grant of the right of use to the franchisee will be viewed as part of the business operations of the franchisor (i.e., the franchisor embarking on a 'scheme of profit-making') and therefore the amount earned will be of a revenue nature.[311] Should the franchisor agree to transfer some ownership of the intellectual property, the amount received will be considered to be of a capital nature and therefore cannot be included in gross income.[312]

Most franchise agreements do not cede the intellectual property to the franchisee and the franchisor can decide to grant other franchisees the right to use the intellectual property as part of the operations of a franchise.[313] Based on the decision of the *BP Southern Africa (Pty) Ltd v C:SARS* case[314], the terms of the agreement should be looked into. If the royalty amounts that were paid were solely for acquiring the use of the intellectual property, there is a possibility that the nature of the expense will be considered to be of a revenue nature and therefore deductible against income.[315] A determination should be made on the significance of the use of the intellectual property on the franchisee's business, particularly if the use of the intellectual

[308] Wallrich, n.d., *'The tax implications of a franchise arrangement: Franchise perspective'*, Wallrich, viewed on 28 May 2021, from http://www.wallrich.co.za/index.php/8-newsletter-articles/30-the-tax-implications-of-a-franchise-arrangement-franchise-perspective-2016 on para.7

[309] Wallrich, n.d., *'The tax implications of a franchise arrangement: Franchise perspective'*, Wallrich, viewed on 28 May 2021, from http://www.wallrich.co.za/index.php/8-newsletter-articles/30-the-tax-implications-of-a-franchise-arrangement-franchise-perspective-2016 on para.7

[310] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.8

[311] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.8

[312] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.8

[313] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.9

[314] 2007 SCA 7 (RSA) 69 SATC 79

[315] *BP Southern Africa (Pty) Ltd v C:SARS*, 2007 SCA 7 (RSA) 69 SATC 79

property has an impact on the franchisee's market share in the area in which it operates.[316] Further consideration should be made on whether the franchisee would like to develop its intellectual property for the continuation of its business operations should the franchise agreement end.[317]

Should it be proven that the royalty payments form part of the business operations and the amounts incurred have a causal link to the overall business purpose[318], the royalty payments may qualify for a deduction in terms of s 11(a) of the Income Tax Act.

The renewal fees may be incurred by the franchisee once the initial franchise term has ended and the franchisee wishes to continue its relationship with the franchisor.[319] The renewal fees are considered to have the same nature as the 'initial franchise fees' and as such, be considered capital in nature for the franchisee.[320] The franchisor will be expected to include the amounts received in gross income in terms of para (g) and para (gA) of the gross income definition, as contained in s 1 of the Income Tax Act.[321]

5.1 Franchise agreement early cancellation

Section 7 of the Consumer Protection Act[322] allows for the cancellation of the franchise agreement into which the franchisee was entered. The waiver of the penalties or cost will be put in place if the cancellation of the franchise agreement occurs before the lapse of 10 business days after the franchise agreement was finalised and signed.[323] It should be noted

[316] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.9

[317] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.9

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

[319] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.15

[320] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.15

[321] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.15

[322] 68 of 2008

[323] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.15

that the franchisee should give a written notice for the cancellation to take effect.[324] In the case where the franchise agreement is cancelled after the cooling-off period of 10 business days, either of the parties which instituted the cancellation of the agreement will be liable to pay the other party a penalty or an amount of a similar nature.[325]

In the instance where the franchisor cancels the franchise agreement with the franchisee to find a suitable replacement, the penalty incurred in that regard will be allowed as a deduction (as per s 11(a)) in the hands of the franchisor.[326] This is because the penalty would have been incurred to optimise franchisor's earnings by finding a suitable franchisee and therefore such cancellation would occur as part of the franchisor's business operations.[327] In the case where the franchisor no longer wishes to franchise its business, but rather operate it, the penalties that will be incurred to terminate the agreement in this regard will be considered to be amounts of a capital nature as there is an adjustment which is made to a significant part of the 'income-earning operations' and structure of the business.[328] This means that the penalties incurred cannot be deductible in terms of s 11(a) as the penalties are capital in nature.[329] From the franchisee's perspective regarding the receipt or accrual of these payments, it should be determined whether the cancellation of the agreements affected the profits of the particular year or affected the ability of the franchise to generate income as a whole.[330]

The principle determined in the *ITC 1557* case[331] states that the compensation, received by a person for ceasing operations and 'closing down', will be of a capital nature. A similar principle

[324] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.15

[325] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.15-16

[326] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.16

[327] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.16

[328] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.16

[329] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.16

[330] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.22

[331] (1992) 55 SATC 218 (T)

was established in the *WJ Fourie Beleggings CC v C SARS*[332] whereby it was determined that the compensation received for the permanent loss or the rendering of an asset as no longer usable, should be treated as an amount which is of a capital nature. The *Inland Revenue v Fleming & Co (Machinery) Ltd*[333] case states when an amount is paid to the other person for the crippling of 'the whole structure of the recipient's profit-making apparatus', the amount received is 'for the loss or sterilisation of the capital asset' and as such, the amount is of a capital nature.

There is a possibility that the franchisee may opt-out of the franchise agreement due to experiencing financial challenges which may hinder the franchisee's ability to continue the franchise trade.[334] As such the franchisee may claim the penalty amount as revenue in nature, provided that it can be proven that the amount was incurred during the production of income.[335] The penalties paid to the franchisor as compensation will be considered as an amount which is of a capital nature (as it puts an end to the agreement which, as a result, alters the income-earning structure of the business).[336] This amount of compensation will be considered as a base cost amount for capital gains tax (CGT) purposes for the franchisee.[337] In the case of the franchisee contravening certain clauses of the franchise contract, the amount incurred by the franchisee will be considered to be closely related to the 'income-earning operations' and therefore the nature of the penalties for the contravention of the contract will be of a capital nature.[338]

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[332] 70 SATC 8 at 16

[333] (1951) 33 TC 57

[334] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.17

[335] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.17 **and** *Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936 CPD 241, 8 SATC 13.

[336] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.18

[337] Wallrich, n.d., *'The tax implications of a franchise arrangement: Franchise perspective'*, Wallrich, viewed on 28 May 2021, from http://www.wallrich.co.za/index.php/8-newsletter-articles/30-the-tax-implications-of-a-franchise-arrangement-franchise-perspective-2016 on para.10

[338] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.19

The costs of advertising are managed through the advertising fund which is set up by the franchisor.[339] The fees paid could also include the franchisor's compensation for managing the fund.[340] To understand the role of advertising, the trade marks and 'marketing indicia' are used to promote the products and/or services provided by a person as well as to distinguish these products and/or services from those that are also available on the market.[341]

In the course of determining the tax treatment of the advertising fees received or accrued and the advertising costs incurred, it is important to establish whether the advertising fees are paid directly into the franchisor's bank account or whether there has been a company or trust that has been set up specifically for managing the advertising fees paid and advertising costs incurred.[342] If a separate company or trust was set up specifically for managing the advertising fees and advertising costs, then the amount received by or accrued will constitute gross income and the amounts expended for the promotion of the products and/or services may be deductible per s 11(a) of the Income Tax Act.[343]

If the franchisor is compensated for the advertising costs directly expended by it, the fees received will be included in its gross income and the advertising costs incurred may be deductible as per the provisions of s 11(a) of the Income Tax Act (unless the amount can be proven to be of a capital nature, then a capital allowance may be claimed).[344]

In the franchisee's hands, the advertising costs may be claimable against s 11(a) when proven that the advertising costs were incurred in the daily operations of the business and did not create an 'enduring benefit'.[345] One of the indicating factors that can be used to determine that the amount is of revenue in nature is to establish whether the benefit or the advantage of the

[339] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.25

[340] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.25

[341] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.25

[342] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.25

[343] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.25

[344] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.25

[345] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.25

advertisement costs has been short-lived and therefore, regular advertising costs would then need to be incurred.[346]

In terms of the training fees, the franchisor will be expected to include the amount received and/or accrued in gross income and deduct the expenses incurred in terms of section 11(a).[347] The franchisee may claim the training fees it incurs against section 11(a) as these training fees are incurred with the prospect of improving the business' operations.[348]

The restraint of trade payments may be incurred by the franchisor, after the termination of a franchise agreement, with the aim that its intellectual property and other business secrets are preserved and that the franchisor will still be able to conduct business after the termination of the specific franchise agreements with one of the franchisees.[349] The nature of the restraint of trade compensation is capital in nature as it affects the 'income-earning structure'.[350] The franchisor will only be able to claim the restraint of trade deduction against s 11(cA) if the amount was paid to a franchisee who was operating as a sole proprietor.[351]

5.2 Conclusion

A franchisor should consider the tax implications of the amounts 'received or accrued' and amounts incurred regarding intellectual property.[352] The amount paid for the grant of access to the intellectual property, by the franchisee, is likely to be considered as a capital nature amount as the amount forms the foundation (amongst other amounts) upon which the

[346] South African Revenue Service, 2021, *Guide on the Taxation of Franchisors and Franchisees,* South Africa Revenue Service, South Africa, viewed on 21 June 2022, available from https://www.sars.gov.za/wp-content/uploads/Ops/Guides/LAPD-IT-G23-Guide-on-the-Taxation-of-Franchisors-and-Franchisees.pdf on pg.25

[347] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.20

[348] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.20

[349] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.22

[350] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.22

[351] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.22

[352] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.6

franchisee operates.[353] The royalty amount incurred by the franchisee may be considered as a revenue nature amount, but the franchisee will have to prove that the amount incurred relates to the daily operations of the franchise.[354]

The amounts that are paid by the franchisor or franchisee regarding the early cancellation of the franchise agreement should be scrutinised, based on the facts, to determine whether the amount incurred is of a capital nature.[355] This too applies in the instance where the amount is received by either party when the amount has been paid by the other party.[356]

[353] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.7 and s 11(f)(iii)

[354] *BP Southern Africa (Pty) Ltd v C:SARS*, 2007 SCA 7 (RSA) 69 SATC 79

[355] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.16 and 22

[356] *ITC 1557*(1992) 55 SATC 218 (T)

Chapter 6: Withholding tax on royalty payments

This chapter briefly discusses how the withholding taxes on royalties arise. Article 12 of the OECD is also referred to as withholding tax mostly relates to royalties which are paid to non-residents.

The withholding tax on royalties is governed by ss 49A to 49H of the ITA. The royalty payments are related to the right of use of the intellectual property (and the premium amounts paid) as well as commercial knowledge, technical, scientific or industrial knowledge and support for any article which will be used by the payer in South Africa.[357] The withholding taxes on royalties will apply in the case where the payment is made to a non-resident.

As per s 49B(1) of the ITA, the withholding tax on royalties is 15%. It should be noted, as stipulated in s 49E(1) of the ITA that the taxpayer paying the royalty will be liable to withhold the tax and pay it over to SARS 'by the last day of the month following the month during which the royalty is paid...'.[358]

Paragraph 1 of Article 12 of the OECD Model Tax Convention states that the tax on the royalties must be levied in the jurisdiction in which the intellectual property is used.[359] Paragraph 3 of Article 12 of the OECD Model Tax Convention states that if the recipient of the royalty payment has a permanent establishment in the jurisdiction in which the royalty payments arise and the royalty payments were therefore connected to that permanent establishment, Article 12 would not apply.[360] In this case, the royalty payments will be taxed in the jurisdiction wherein the permanent establishment operates.[361]

In the case where there is a double tax agreement with the foreign tax authority of the country in which the non-resident is a resident, the withholding tax rate on the royalty may be reduced by the amount stipulated in the double tax agreement.[362] In addition to that, the non-resident should supply a declaration of the adjusted rate as per the double tax agreement.[363] Should the circumstances change, the non-resident should supply the payer with an undertaking

[357] South African Revenue Service, 2021, *'Withholding Tax on Royalties'*, South African Revenue Service, viewed on 16 June 2022 available from https://www.sars.gov.za/types-of-tax/withholding-tax-on-royalties/#:~:text=Royalties%20paid%20is%20taxed%20at,withholding%20tax%20rate%20of%2015%25.on para.3

[358] Sections 49E(1) and 49F(1) of the ITA

[359] OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.14

[360] OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.14

[361] OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.10

[362] Section 49E(3)(a) of the ITA

[363] Section 49E(3)(a) of the ITA

which will detail the changed circumstances.[364] This is aligned to s 10(1)(l) of the ITA as it states that the royalty amount that was received by the non-resident through its permanent establishment will not be exempt from income as defined.[365] Furthermore, due to royalties not being exempted from income as defined, the royalty payments will not be subject to withholding tax as a result of a permanent establishment existing in the jurisdiction from which the royalty payments are received.[366] This also applies to a non-resident natural person who was 'physically present' in South Africa for more than 183 days (the days are accumulated for each 12-month period which starts before the royalty payment was received).[367]

6.1 Conclusion

Withholding tax on royalties will be imposed on the amount 'received or accrued' to a non-resident who granted the 'right of use of intellectual property' to another party.[368] The withholding tax on royalties, will however, be a result of the exemption of the amount from gross income in terms of s 10(1)(l).[369]

[364] Section 49E(3)(b) of the ITA
[365] Section 10(1)(l)(ii) of the ITA
[366] Section 49D(b) of the ITA
[367] Sections 10(1)(l)(i) and 49D(a) of the ITA
[368] Paragraph (g)(iii) of the gross income definition of the ITA
[369] As contained in the ITA

Chapter 7: Section 23I for tainted intellectual property

This chapter discusses when intellectual property is perceived to be tainted, as well as the tax implications thereof.

Section 23I was created to address the sale and leaseback agreements which parties may enter into regarding intellectual property.[370] Taxpayers have entered into arrangements whereby the person who developed the intellectual property would dispose it of to another person who either is a non-resident for South African purposes or is exempt from income.[371] The intellectual property will then be leased out to either the party who initially created the intellectual property or another party.[372] Intellectual property is defined in s 23I of the ITA as designs, copyright, patents, trade marks and property that may have qualities which resemble those mentioned.[373] The definition also includes the skill imparted regarding how intellectual property should be used.[374]

Section 23I serves as an anti-avoidance provision which seeks to discourage the ceding of intellectual property which was created in South Africa to a jurisdiction that imposes low taxes, to only be subject to a licence agreement where the right to use the intellectual property will be granted to the South African creator of the intellectual property or the connected person thereof.[375] The intellectual property will be owned by the non-resident but there is a chance that the non-resident will not be subjected to the South African tax on the royalties received and/or accrued to it.[376] This anti-avoidance provision was inserted in the legislation to protect

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[370] Margo, D., n.d., *'Claiming deductions for royalty payments? Beware any "Tainted IP": A rude surprise awaits'*, Margo Attorneys, viewed on 27 May 2022, from http://www.margoip.co.za/royaltyPayments.html on para.3

[371] Orbitax, 2022, *'South Africa Prohibition of Deductions in Respect of Tainted Intellectual Property'*, Orbitax, viewed on 27 May 2022, from https://www.orbitax.com/news/archive.php/South-Africa-Prohibition-of-De-49913 on para.3

[372] Orbitax, 2022, *'South Africa Prohibition of Deductions in Respect of Tainted Intellectual Property'*, Orbitax, viewed on 27 May 2022, from https://www.orbitax.com/news/archive.php/South-Africa-Prohibition-of-De-49913 on para.3

[373] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.384

[374] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.384

[375] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.12

[376] South Africa Revenue Service, 2018, *South African Revenue Service - Draft Interpretation Note - Prohibition of Deductions for Certain Intellectual Property*, South African Revenue Service, South Africa, viewed on 24 September 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2018-01%20-%20Draft%20IN%20%20Prohibition%20of%20deductions%20for%20certain%20intellectual%20property.pdf

South Africa's tax base.[377] It should be noted, however, that section 23I will not apply in the instance where the sale and leaseback arrangement has occurred between South African persons who are liable to pay taxes.[378]

Section 23I refers to tainted intellectual property whereby the compensation for the use of the intellectual property by the user to the licensor is not considered as income in the hands of the licensor.[379] An example of this would be that the intellectual property is granted by the licensor who is recognised by the SARS Tax Exemption Unit (TEU) as a taxpayer who is exempt from tax.[380]

An allowance must not be granted to the taxpayer who acquired the expense which represents the premium for the 'right of use' and the fees associated with the use of the 'tainted intellectual property'.[381] This is the case whereby the same amount will not be considered as income in the hands of the licensor or the amount will not form part of the 'proportional amount of net income' which should be determined for a controlled foreign company.[382] The prohibition of the allowance extends to the creation of a financial instrument through the conversion of the royalty payments.[383] These amounts would then be allocated to other entities and the taxation of the amount will be subject to a decreased 'effective tax rate'.[384]

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[377] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.13

[378] Margo, D., n.d., *'Claiming deductions for royalty payments? Beware any "Tainted IP": A rude surprise awaits'*, Margo Attorneys, viewed on 27 May 2022, from http://www.margoip.co.za/royaltyPayments.html on para.5

[379] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.384

[380] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.384

[381] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.384

[382] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.384

[383] Stiglingh, M. (ed.), Koekemoer, A.D., van Heerden, L., Wilcocks, J.S. & van der Zwan, P., 2019, *Silke: South African Income Tax - 2019*, Lexis Nexis, Durban on pg. 412

[384] Stiglingh, M. (ed.), Koekemoer, A.D., van Heerden, L., Wilcocks, J.S. & van der Zwan, P., 2019, *Silke: South African Income Tax - 2019*, Lexis Nexis, Durban on pg. 412

'Tainted intellectual property' is defined as intellectual property:[385]

(a) 'which was the property of the end user or of a taxable person that is or was a connected person, as defined in section 31(4), in relation to the end user;
(b) which is the property of a taxable person;
(c) a material part of which was used by a taxable person in carrying on a business while that property was the property of a taxable person and the end user of that property acquired that business or a material part thereof as a going concern; or
(d) which was discovered, devised, developed, created or produced by the end user of that property, or by a taxable person that is a connected person, as defined in section 31(4), in relation to the end user, if that end user, together with any taxable person that is a connected person in relation to that end user, holds at least 20 per cent of the participation rights, as defined in section 9D, in a person by or to whom an amount is received or accrues-
    i. by virtue of the grant of use or right of use or permission to use that property; or
    ii. where that receipt, accrual or amount is determined directly or indirectly with reference to expenditure incurred for the use or right of use or permission to use that property;'

It should be noted that a connected person concerning a company is a company which owns equity shares or voting rights which are 20% or more in that other company.[386]

Paragraph (c) of the 'tainted intellectual property' was inserted as the disposal of intellectual property in the process of acquisition and merger transactions by non-residents could deny South Africa of the royalty income and therefore decrease the tax base.[387] The material part is considered to be a significant part (which is defined to be 20% or more).[388]

Regarding the term 'carrying on a business', guidance can be obtained from the *Estate G v COT*[389] case, where the courts established that all the activities should be considered holistically to determine whether a business is being conducted continuously. In the cases of *Platt v CIR*[390] and *Smith v Anderson*[391], it was established that a business is an activity wherein someone dedicates his time and effort to continue and does so intending to derive profit. The judgment in *Milner Street Properties (Pty) Ltd v Eckstein Properties (Pty) Ltd*[392] relied on the judgments that were delivered in *General Motors SA (Pty) Ltd v Besta Auto Component*

[385] Section 23(I)(1) of the ITA
[386] South Africa Revenue Service, 2018, *South African Revenue Service - Draft Interpretation Note - Prohibition of Deductions for Certain Intellectual Property*, South African Revenue Service, South Africa, viewed on 24 September 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2018-01%20-%20Draft%20IN%20%20Prohibition%20of%20deductions%20for%20certain%20intellectual%20property.pdf on pg.6

[387] South Africa Revenue Service, 2018, *South African Revenue Service - Draft Interpretation Note - Prohibition of Deductions for Certain Intellectual Property*, South African Revenue Service, South Africa, viewed on 24 September 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2018-01%20-%20Draft%20IN%20%20Prohibition%20of%20deductions%20for%20certain%20intellectual%20property.pdf on pg.8

[388] South Africa Revenue Service, 2018, *South African Revenue Service - Draft Interpretation Note - Prohibition of Deductions for Certain Intellectual Property*, South African Revenue Service, South Africa, viewed on 24 September 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2018-01%20-%20Draft%20IN%20%20Prohibition%20of%20deductions%20for%20certain%20intellectual%20property.pdf on pg.8
[389] 1964 (2) SA 701 (SR), 26 SATC 168 at 172 and 173
[390] 1922 AD 42, 32 SATC 142 at 148
[391] (1880) 15 ChD 247 at 258
[392] 62 SATC 451 at 461

Manufacturing (Pty) Ltd[393], *Ferne v Wilson*[394] and *Electricity Commission (Balmain Electric Light Co Purchase) Act*[395] which defined a 'going concern' as a business which continues its operations to such an extent that if the business were to be sold, the business would still be functional in the hands of another, including its customer base being retained.

Paragraph (d) of the 'tainted intellectual property' definition relates to a scenario whereby a taxable person, who developed or created the intellectual property, is a connected person to the non-resident through the taxable person and the end user holding 20% or more of the participation rights (which are defined in s 9D) of this non-resident or the taxable person's connected person holding such participation rights in the non-resident.[396] It should be noted that the taxable person and the end user should be connected persons.[397] Participation rights (as defined in s 9D of the ITA) mean advantages from which a shareholder can benefit concerning the share that it owns.[398] In the case where the participation rights cannot be ascertained, reliance will be placed on the voting rights.[399]

'End user' is defined in s 23I(1) of the ITA as a person who has a permanent establishment in South Africa or who is a person that is subject to tax and utilises the intellectual property or invention in a tax year to produce income. This excludes a person whose main trade is to extend the 'use or right of use or permission to use intellectual property or any corresponding invention'.

The definition of 'taxable person' as contained in s 23I(1) excludes some taxpayers, such as a public benefit organisation (PBO) and a non-resident. Trading stock (s 22) and the acquisition or purchase of intellectual property (s 11(gC)) are excluded from s 23I even though the requirements in s 23I may be met.[400]

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[393] 1982 (2) SA 653 (SECLD) at 657
[394] (1900) 26 VLR 422 at 437
[395] 1950 (1957) SR (NSW) 100 at 131
[396] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.12

[397] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.12
[398] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.13
[399] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.13
[400] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020,

Section 23I(2)(a) refers to 'any amount of expenditure incurred'. To determine the meaning of the 'word' amount, reference should be made to case law. In the *W H Lategan v CIR*[401] case, it has been expressed that 'amount' should include

> '"…the value of every form of property earned by the taxpayer whether corporeal or incorporeal which had a money value"'

The *C:SARS v Brummeria Renaissance (Pty) Ltd & others*[402] case creates the emphasis that all kinds of property and benefit will have a monetary value and a determination thereof will have to be made.

Section 23I(2)(a) does not allow the royalty deduction in the instance where the corresponding receipt or accrual is not taxable in the hands of a recipient.[403] Section 23I(2)(b) prohibits the deduction of royalty expenses which take the form of 'credit default swaps' and 'promissory notes' which is a way for taxpayers to avoid paying taxes.[404]

A controlled foreign company is formed in the instance where a South African resident(s) own(s) above 50% of participation rights above 50% of participation rights (if no participation rights, then voting rights), in a foreign company.[405] This will lead to the 'proportional amount of the net income' of that controlled foreign company being included in the residents' income for a particular year of assessment in terms of s 9D.[406] The 'proportional amount of the net income' of that controlled foreign company includes the royalty amount that was received by or accrued to the controlled foreign company by the licensing agreement with the South African resident.[407] Should the net income of the controlled foreign company be imputed in the

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available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.384

[401] 1926 CPD 203, 2 SATC 16 at 19

[402] 2007 (6) SA 601 (SCA), 69 SATC 205

[403] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.14

[404] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.13

[405] South Africa Revenue Service, 2018, *South African Revenue Service - Draft Interpretation Note - Prohibition of Deductions for Certain Intellectual Property*, South African Revenue Service, South Africa, viewed on 24 September 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2018-01%20-%20Draft%20IN%20%20Prohibition%20of%20deductions%20for%20certain%20intellectual%20property.pdf on pg.15

[406] South Africa Revenue Service, 2018, *South African Revenue Service - Draft Interpretation Note - Prohibition of Deductions for Certain Intellectual Property*, South African Revenue Service, South Africa, viewed on 24 September 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2018-01%20-%20Draft%20IN%20%20Prohibition%20of%20deductions%20for%20certain%20intellectual%20property.pdf on pg.15

[407] South African Revenue Service, 2016, *Draft Guide on the Taxation of Franchisors and Franchisees*, South African Revenue Service, South Africa, viewed on 14 July 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-02%20-%20Draft%20Guide%20on%20the%20taxation%20of%20franchisors%20and%20franchisees.pdf on pg.13

South African resident's taxable income, the royalty amount will be fully deductible.[408] If the royalty income is not included in the 'proportional amount of the net income' of that controlled foreign company, then the end user will not be able to deduct the royalty expenditure against its income.[409] When a controlled foreign company is highly taxed (i.e., all the taxes paid by the controlled foreign company would have been 67.5 per cent of the normal tax calculated in South Africa had the controlled foreign company been a South African resident), the taxable income would be nil and also the royalties that were paid to the controlled foreign company can be fully claimed by the person who paid the royalties.[410]

Section 49B of the ITA levies the withholding tax on royalties at 15%. Previously, the rate levied was 12% (from 1 July 2013 to 31 December 2014).[411] Section 23I(3)(a) of the ITA grants a relief of one-third of the royalty expense related to 'tainted intellectual property' whereby the royalty withholding tax is reduced to 10% through a double tax agreement.[412] Section 23I(3)(b) of the ITA grants relief of half of the royalty expense if the royalty is regarded as 'tainted intellectual property' and the withholding tax which was paid was an equivalent of 15%. In terms of the withholding tax which is levied at 12% for the period between 1 July 2013 to 31 December 2014, a third of the royalty expenditure will be allowed as a deduction.[413] It should be noted that section 23I(3)(a) will not be allowed should the double tax agreement only permit that the withholding tax on royalties be less than 10%.[414]

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[408] Bennett, A., Chong, J., Miller, K. & Veitch, K., 2017, '*Notable amendments in the Taxation Laws Amendment Bill – Part 2'*, Webber Wentzel, viewed on 27 May 2022, from https://www.webberwentzel.com/News/Pages/notable-amendments-in-the-taxation-laws-amendment-bill-part-2.aspx on para.5

[409] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.19

[410] Bennett, A., Chong, J., Miller, K. & Veitch, K., 2017, '*Notable amendments in the Taxation Laws Amendment Bill – Part 2'*, Webber Wentzel, viewed on 27 May 2022, from https://www.webberwentzel.com/News/Pages/notable-amendments-in-the-taxation-laws-amendment-bill-part-2.aspx on para.5; **and** South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.20

[411] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.18

[412] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.18

[413] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.18

[414] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.18

Section 23B does not allow for an amount to be deducted from income under more than one section.[415] It should be noted that an amount can only be allowed as a deduction under s 11(a) in the case where the amount could not be allowed as a deduction under any other section.[416] In the case where a partial deduction could be allowed under a specific section, the rest of the deduction will not qualify as such under s 11(a) of the ITA.[417]

Section 23B, therefore, gives the direction for deduction to say that the specifically catered section for the allowance should be considered first before the allowance can take place in s 11(a).[418] One should be reminded that most of the time, only one section shall be used to deduct the expense.[419]

7.1 Conclusion

The discussion above defined tainted intellectual property, end user and taxable person and also revealed instances where s 23I will apply with regards to licensing agreements.[420] Furthermore, it discussed the relief from which a taxpayer may benefit based on the rate of withholding tax which was withheld on royalties.[421]

[415] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.385

[416] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.385

[417] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.385; s 23B(3)(a)

[418] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.385

[419] Oosthuizen, R., 2013, 'A Framework for the Income Tax Deductibility of Intellectual Property Expenditure incurred by South African Taxpayers', *International Business & Economics Research Journal* 12(3), 373-386, viewed on 22 September 2020, available from https://repository.up.ac.za/bitstream/handle/2263/32427/Oosthuizen_Framework%282013%29.pdf?sequence=1&isAllowed=y on p.g.385

[420] South African Revenue Service, 2022, *South African Revenue Service - Interpretation Note 120: Prohibition of Deductions in Respect of Certain Intellectual Property*, South Africa Revenue Service, South Africa, viewed on 27 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-INTR-IN-2022-02-IN120-Prohibition-of-deductions-in-respect-of-certain-intellectual-property.pdf on pg.2

[421] As contained in s 23I(3) of the ITA

Chapter 8: Tax treatment for the amounts received or accrued for the exploitation of image rights

Image rights are used by companies to market their products and build their brand so that their sales can increase.[422] Some sportspersons received remuneration from their sports clubs through payments for the exploitation of their image rights.[423] A matter for consideration is whether the image rights of the player can be seen as a distinct source of income from his sports services.[424] Image rights are related to the potential of the commercial advantage that a person has regarding their features such as signature or image and making decisions on how their features can be used to generate money.[425] Other features to which image rights can be assigned are photographs, the player's name, voice, nickname and reputation.[426]

It should be noted, however, that there is no protection in South African law regarding the exploitation of image rights.[427] The only protection that can be offered to rights which are similar to image rights is the protection of trade marks and copyrights.[428] The common law and the Constitution should then be considered when the image rights have been infringed upon. The relevant sections of the Constitution are as follows:[429]

- s 10: Human dignity
- s 12: Freedom and security of the person (specifically subsec 2)
- s 14: Privacy

In Europe, image rights are considered equal to human rights which can be used for trade.[430] Common law is used for determining the infringement of image rights (which are cited to be

[422] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.556
[423] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.557
[424] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.557
[425] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.557
[426] South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.29

[427] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.557
[428] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.557
[429] 108 of 1996
[430] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.558

personality rights) and therefore it is recognised that loss of commercial value will be presented when the image rights are violated.[431]

In instances whereby the sports professional or celebrity is earning income from a foreign source, that income will be taxed in South Africa if that sports professional or celebrity is a South African resident.[432] It should be noted, that the foreign-sourced income may be taxed in the foreign country and this may lead to double taxation which can be remedied through the use of tax treaties (i.e. agreements between countries for the main purpose of providing relief from double taxation).[433] Section 6quat of the ITA provides for a rebate against the normal tax calculated for the taxes paid on foreign amounts that were received and also allows the taxpayer to deduct the foreign taxes against taxable income (if the amount is of a South African source).[434]

A taxpayer is welcome to structure their tax affairs in a manner that is deemed fit for him.[435] It should be understood, however, that the tax schemes should be in line with legislation and would be seen as adhering to the anti-avoidance rules as set out in ss 80A to 80L of the ITA.[436]

The definition of employee is provided in the Fourth Schedule (particularly par 1) of the ITA and includes[437]

> 'a person who receives remuneration…or to whom remuneration accrues'

An independent contractor, on the other hand, is a person who performs duties and services for an employer, however, this is per the agreement whereby the independent contractor performs the services when requested, and stipulates which services he or she will perform.[438]

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[431] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.558-559

[432] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.565

[433] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.565

[434] Section 6quat of the ITA; **and** South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.57

[435] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.566-567

[436] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.567

[437] Paragraph a of the definition of an employee in the Fourth Schedule of the ITA; **and** South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf pg. 3

[438] South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf pg. 3

The contract between the employer and the independent contractor will allow the independent contractor the flexibility of performing the duties without a schedule (but there would be a delivery date) and the flexibility of how the services will be performed.[439]

What should be considered is that image rights (which are considered to be personal rights) cannot be alienated from a person.[440] In the case of *ITC 1735*[441], the sports professional received remuneration for the exploitation of his image rights. The case was therefore concerned on whether the amount will be of a capital nature.[442] It was established by the courts that the compensation received by a person for the exploitation of their image rights will be included in gross income.[443] This is because the image rights of the golfer (whose image rights were used to promote a tournament) were not alienated or sold off and he can decide on how his image rights can be exploited.[444]

Interpretation Note 17 (Issue 5), which was published by SARS, can be used as a tool to determine whether it would be appropriate for a celebrity or an influencer to be classified as an independent contractor. This would be based on the type of relationship established by the contractual agreement for the type of benefits that the company would derive from the exploitation of the image rights of the celebrity or influencer. The important aspect that should be considered is whether remuneration was paid to the individual.[445] In accordance with subpara (ii) of the exclusionary para of the definition of remuneration as contained in para 1 of the Fourth Schedule, a person can be considered to not be an employee if the services he renders are done separately from the employer-employee relationship.

The other factors that may indicate that the individual is an independent contractor is that the services do not have to be rendered at the client's place of business, the individual is not

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[439] South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf pg. 3

[440] South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.29

[441] 64 SATC 455

[442] *ITC 1735* 64 SATC 455

[443] *ITC 1735* 64 SATC 455

[444] South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.29

[445] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 17: Employees Tax: Independent Contractors (Issue 5)*, South African Revenue Service, South Africa, viewed on 30 April 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-17%20-%20Employees%20Tax%20Independent%20Contractors.pdf on pg.3

expected to perform the duties within working hours and there is limited control or supervision over this individual.[446] It is possible that a celebrity or influencer may be in agreement with one company in terms of the exploitation of the image rights for gains but be paid by another company or person.[447] It is important to note that the celebrity or influencer will have to be independent of both parties so that the amount paid is not considered as remuneration.[448] Section 80(1)(a)(vii) of the Tax Administration Act[449] states that an advanced ruling will not be issued for determining if a person could qualify as an independent contractor. An arrangement, however, can be made that PAYE be withheld for the independent contractor.[450]

The summary table drafted by SARS regarding the standard employment is silent on whether 25% should be withheld as PAYE on the amount earned by a person who lends their services to a company or another entity for less than five hours, but, may earn an amount which is greater than R366 per day.[451] Celebrities (particularly influencers) may have a short-term agreement which may require the person to work for the company who would like to exploit their image rights and/or benefit from other services and may work for less than five hours a day at a time. The influencer or celebrity may request that a flat rate of 25% is applied against the amount earned.[452] It should, however, be established whether there has been an agreement regarding how the duties will be performed by each party, which will most likely indicate an employee-employer relationship e.g., the celebrity being restricted from entering

[446] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 17: Employees Tax: Independent Contractors (Issue 5)*, South African Revenue Service, South Africa, viewed on 30 April 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-17%20-%20Employees%20Tax%20Independent%20Contractors.pdf on pg.4-5 **and** exclusionary paragraph of 'remuneration as defined in paragraph 1 of the Fourth Schedule of the ITA

[447] This point is made in reference with South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 17: Employees Tax: Independent Contractors (Issue 5)*, South African Revenue Service, South Africa, viewed on 30 April 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-17%20-%20Employees%20Tax%20Independent%20Contractors.pdf on pg.5

[448] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 17: Employees Tax: Independent Contractors (Issue 5)*, South African Revenue Service, South Africa, viewed on 30 April 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-17%20-%20Employees%20Tax%20Independent%20Contractors.pdf on pg.5

[449] 28 of 2011

[450] Visser, A., 2020, *'Paying the tax man in a changing employment landscape'*, Finweek, viewed on 16 June 2022, available from https://www.news24.com/fin24/Finweek/Featured/paying-the-tax-man-in-a-changing-employment-landscape-20200406 on para.18

[451] South African Revenue Service, n.d., *South African Revenue Service - Guide For Employers in Respect of Employees' Tax (2023 Tax Year)*, South African Revenue Service, South Africa, viewed on 14 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf on pg.28

[452] Visser, A., 2020, *'Paying the tax man in a changing employment landscape'*, Finweek, viewed on 16 June 2022, available from https://www.news24.com/fin24/Finweek/Featured/paying-the-tax-man-in-a-changing-employment-landscape-20200406 on para.18

into a contract with a similar company as the company with which the celebrity/influencer is associated.[453]

The agreement that is drafted between the sports club and the sports professional may result in an employer-employee relationship as the sports professional would be performing duties under the supervision of the sports club.[454] As such, the club would have to ensure that the employees' tax is withheld and the amount is shown on the IRP5 certificate.[455] The similar amounts received such as appearance fees and endorsement fees, will also be treated as revenue in nature amounts and will therefore be included in gross income.[456]

8.1 Conclusion

An individual may be compensated where an entity has exploited his or her image rights.[457] The amount 'received or accrued' should be included in the individual's gross income for a specific year of assessment.[458] There are instances whereby the sports professional, celebrity or influencer is granted a contract by an entity whereby there will be regular income that will be received for the continuous exploitation of image rights.[459] Consideration should be made on whether the celebrity, influencer or sports professional will be viewed as an independent contractor in this instance.[460] It was found that should it be the case, the sports professional, celebrity or influencer can request that 25% be withheld as PAYE on the income he or she

[453] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 17: Employees Tax: Independent Contractors (Issue 5)*, South African Revenue Service, South Africa, viewed on 30 April 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-17%20-%20Employees%20Tax%20Independent%20Contractors.pdf on pg.8

[454] South African Revenue Service, n.d., *South African Revenue Service - Guide For Employers in Respect of Employees' Tax (2023 Tax Year)*, South African Revenue Service, South Africa, viewed on 14 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf on pg.30

[455] South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.30

[456] South African Revenue Service, n.d., *Draft Guide on The Taxation of Professional Sports Clubs and Players*, South African Revenue Service, South Africa, viewed on 2 August 2020, available from https://www.sars.gov.za/AllDocs/LegalDoclib/Drafts/LAPD-LPrep-Draft-2016-43%20-%20Draft%20Guide%20on%20the%20Taxation%20of%20Professional%20Sports%20Clubs%20and%20Players.pdf on pg.30

[457] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.557

[458] As per the gross income definition contained in s 1 of the ITA

[459] Cloete, R., 2012, 'The taxation of image rights: A comparative analysis', *De Jure*, vol. 45(3). pp. 556-567, viewed on 2 August 2020, available from http://www.scielo.org.za/pdf/dejure/v45n3/07.pdf on p.g.557

[460] South African Revenue Service, 2019, *South African Revenue Service - Interpretation Note 17: Employees Tax: Independent Contractors (Issue 5)*, South African Revenue Service, South Africa, viewed on 30 April 2020, from https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2012-17%20-%20Employees%20Tax%20Independent%20Contractors.pdf on pg.3

earned.[461] In the instance where the sports professional has entered into a contract with a sports club and it was agreed, in writing, that an amount will be paid to the sports professional for the exploitation of his image rights, the amount paid, as such, will be considered as remuneration and an appropriate amount of PAYE will have to be calculated.[462]

[461] Visser, A., 2020, *'Paying the tax man in a changing employment landscape'*, Finweek, viewed on 16 June 2022, available from https://www.news24.com/fin24/Finweek/Featured/paying-the-tax-man-in-a-changing-employment-landscape-20200406 on para.18

[462] South African Revenue Service, n.d., *South African Revenue Service - Guide For Employers in Respect of Employees' Tax (2023 Tax Year)*, South African Revenue Service, South Africa, viewed on 14 May 2022, available from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-IN-2012-06-IN-6-Resident-Place-of-effective-management-companies.pdf on pg.30

Chapter 9: Capital gains tax treatment of intellectual property

The gross income, as well as the general deduction formula definitions, excludes amounts of a capital nature. Section 26A of the ITA, however, allows for the inclusion of taxable capital gains in the calculation of taxable income for a year of assessment and the taxable capital gain at the relevant inclusion rate.[463]

The capital gains will arise when there is disposal or a deemed disposal of an asset.[464] An asset is defined in para 1 of the Eighth Schedule of the ITA as property of any form which includes tangible and non-tangible items.[465] Intellectual property would meet the definition of an asset as it is considered to be property regardless of its intangible nature.[466] Intellectual property can be used to promote a business separate from the goods and services provided by one business from the other (through trade marks).[467] It is formed when inventions are created (which can be considered as designs or can be patented).[468] The works of others (literary or artistic) may be protected through copyrights.[469] Disposal events are set out in para 11 and 12 of the Eighth Schedule of the ITA. The events that will be considered as disposal of intellectual property (as per para 11(a) of the Eighth Schedule) are the cession, sale, conversion, grant, expropriation, transfer or exchange of the intellectual property. Furthermore, the disposal of intellectual property can occur through termination, cancellation, forfeiture, redemption and similar disposal actions.[470] Proceeds is the amount (in cash or otherwise) that is given in exchange for the disposal of intellectual property.[471] The following costs will be included as part of the base cost of the intellectual property:[472]

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[463] Paragraph 10 of the Eighth of the Income Tax Act contains the rates at which the taxable capital gains can be included in the tax calculation of the company

[464] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2810

[465] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2810

[466] Giles, J., 2013, *'What is Intellectual Property or IP?'*, Michalsons, viewed on 23 June 2022, available from https://www.michalsons.com/blog/what-makes-up-intellectual-property/1170 at para.1

[467] Giles, J., 2013, *'What is Intellectual Property or IP?'*, Michalsons, viewed on 23 June 2022, available from https://www.michalsons.com/blog/what-makes-up-intellectual-property/1170 at para.5

[468] Giles, J., 2013, *'What is Intellectual Property or IP?'*, Michalsons, viewed on 23 June 2022, available from https://www.michalsons.com/blog/what-makes-up-intellectual-property/1170 at para.6-7

[469] Giles, J., 2013, *'What is Intellectual Property or IP?'*, Michalsons, viewed on 23 June 2022, available from https://www.michalsons.com/blog/what-makes-up-intellectual-property/1170 at para.4

[470] Paragraph 11(b) of the Eighth Schedule of the Income Tax Act.

[471] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2813

[472] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2814; **and** para.20 of the Eighth Schedule of the ITA

- the costs that are incurred which are related to the purchase or the alienation of the intellectual property;
- the enhancement of intellectual property; and
- the purchase of an intellectual property

The capital gain or capital loss will occur when there is a difference between the proceeds and the base cost amounts.[473] The capital gain will arise if the proceeds are more than the base cost and the capital loss will arise if the base cost is more than the proceeds.[474]

Paragraph 16 of the Eighth Schedule relates to the intellectual property which was obtained before 1 October 2001. This paragraph states that the capital loss of such will be disregarded if the intellectual property was sold off to a connected person or if the disposal of such intellectual property is a result of a merger or acquisition transaction which occurred between connected persons.[475]

Paragraph 2 describes when the calculation of the capital gains will be executed. Intellectual property which is utilised as the permanent establishment would primarily belong to the non-resident who ultimately makes the decisions regarding the acquisition/rental and use of the intellectual property.[476] In this case, para 2(b)(ii) will not apply to the intellectual property which is ultimately owned by the non-resident.[477] It is interesting to note that para 5 of Article 13 of the OECD Model Tax Convention states that the capital gains from the disposal of an asset that is not immovable property; moveable property; ships or aircraft or shares (as described in the paras 1-4) should only be taxed in the jurisdiction where the disposer is a resident.[478]

In accordance with par 10 of the Eighth Schedule, an individual must include the taxable capital; gains in the calculation of taxable income for a particular year at 40%.[479] Persons other than individuals must include the taxable capital gain at 80%.[480]

[473] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2814
[474] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2814
[475] Paragraph 16 of the Eighth Schedule of the ITA
[476] Paragraph 2 of the Eighth Shcdule of the ITA
[477] Paragraph 2 of the Eighth Shcdule of the ITA
[478] OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.15

[479] Specifically par 10(1)(a)
[480] Paragraph 10(1)(c) of the Eighth Schedule of the ITA.

9.1 Conclusion

Capital gains considerations were discussed above for the instances where the intellectual property is sold, since it is viewed as being of a capital nature.[481] An expense incurred which was not considered as revenue in nature is considered to form part of the base cost of the intellectual property.[482] The capital gain or capital loss which arises from the difference between the proceeds and the base costs should be accounted for in the calculation for taxable capital gains for a particular year of assessment.[483]

[481] Disposal events as per para 11 and 12 of the Eighth Schedule of the ITA
[482] Para 20 of the Eighth Schedule of the ITA
[483] Par 3 and 4 of the Eighth Schedule of the ITA; and De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2814

Chapter 10: Effectiveness of the South African transfer pricing provisions for intellectual property against the OECD guidelines

This chapter briefly explains how the transfer pricing provisions apply to intellectual property.

It is found that some multinational enterprises use transfer pricing as a method of avoiding tax and this impacts the collection of tax revenue by some jurisdictions.[484] The 'transfer pricing regulations' are used by tax authorities to monitor inter-company activities which may be used to transfer profits.[485] Multinational enterprises should keep a record of how the transfer prices for intercompany transactions are established which can be used for an audit raised by a tax authority.[486]

Per article 9 of the OECD Model Tax Convention, all the transactions that were entered into with associated enterprises should be looked into (whether financial or commercial) to determine whether the arm's length principle was applied across the board.[487] An associated enterprise is an organisation that partakes in the 'management, control or capital' of another organisation which is in a different jurisdiction from the one partaking in the mentioned activities.[488] This also relates to a main entity and permanent establishments (e.g. branches) which participates in the 'management, control or capital' of another organisation which is in

[484] Ratombo, M. & Blumenthal, R., 2017, *The challenges faced by developing countries regarding transfer pricing*, Southern African Accounting Association Biennial International Conference Proceedings, Drakensberg, South Africa, 2017, p749-767, viewed 24 July 2020, from http://www.saaa.org.za/Downloads/Publications/TAX008%20The%20challenges%20faced%20by%20developing%20countries%20regarding%20transfer%20pricing.pdf on pg. 750

[485] Ratombo, M. & Blumenthal, R., 2017, *The challenges faced by developing countries regarding transfer pricing*, Southern African Accounting Association Biennial International Conference Proceedings, Drakensberg, South Africa, 2017, p749-767, viewed 24 July 2020, from http://www.saaa.org.za/Downloads/Publications/TAX008%20The%20challenges%20faced%20by%20developing%20countries%20regarding%20transfer%20pricing.pdf on pg. 752

[486] Ratombo, M. & Blumenthal, R., 2017, *The challenges faced by developing countries regarding transfer pricing*, Southern African Accounting Association Biennial International Conference Proceedings, Drakensberg, South Africa, 2017, p749-767, viewed 24 July 2020, from http://www.saaa.org.za/Downloads/Publications/TAX008%20The%20challenges%20faced%20by%20developing%20countries%20regarding%20transfer%20pricing.pdf on pg. 753

[487] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.7; **and** OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.11

[488] OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.11

a different jurisdiction.[489] This should lead to the adjustments being made by the enterprise that obtained the tax benefit, provided that both s 31 and the tax treaties (which South Africa entered into) will be applied.[490]

Per para 2 of Article 9 of the OECD Model Tax Convention, the tax authorities of jurisdictions can adjust for the arm's length prices of the related enterprises if both of the enterprises did not apply the arm's length principle in the pricing of their transactions.[491] This is to ensure that the tax base of both jurisdictions is protected.[492] The arm's length price is represented by a range of prices within a particular industry.[493] The price that was set between related parties for the transfer of goods and services is based on the costs as well as the risks that have been covered by the transaction.[494] The comparison of such prices ensures that a transaction which would have been entered into by independent parties is seen as a benchmark for the prices that have been set by connected persons.[495]

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[489] OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.11; **and** Stelloh, M., 2019, *'Transfer pricing change to amass taxpayers'*, BDO, viewed 18 June 2022, from https://www.bdo.co.za/en-za/insights/2019/tax/transfer-pricing-change-to-amass-taxpayers at para.3

[490] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.7

[491] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.8 **and** OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.11

[492] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.8

[493] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.8

[494] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.10

[495] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.10

Paragraph 1 of Article 5 of the OECD Model Tax Convention states that a permanent establishment is a place from where continuous trade is operated.[496] An example of a permanent establishment is a factory, a branch or an office.[497]

Section 31 is an anti-avoidance provision which seeks to adjust the transfer prices to reflect the arm's length amounts at which the prices should have been recorded by the connected persons.[498] For s 31 to apply, there should have been an affected transaction which took place. An affected transaction is defined as follows:

> "**'affected transaction'** means any transaction, operation, scheme, agreement or understanding where –
> (a) that transaction, operation, scheme, agreement or understanding has been directly or indirectly entered into or effected between or for the benefit of either or both-
> (i) (aa) a person that is a resident; and
> (bb) any other person that is not a resident;
> (ii) (aa) a person that is not a resident; and
> (bb) any other person that is not a resident that has a permanent establishment in the Republic to which the transaction, operation, scheme, agreement or understanding relates;
>
> (iii) (aa) a person that is a resident; and
> (bb) any other person that is a resident that has a permanent establishment outside the Republic to which the transaction, operation, scheme, agreement or understanding relates; or
> (iv) (aa) a person that is not a resident; and
> (bb) any other person that is a controlled foreign company in relation to any resident,
> and those persons are connected persons in relation to one another; and
> (b) any term or condition of that transaction, operation, scheme, agreement or understanding is different from any term or condition that would have existed had those persons been independent persons dealing at arm's length;"

The tax benefit obtained would essentially be a reduced amount of tax that is paid, based on the fact that the reduced income is included or that the larger deduction is claimed as compared to the market norms.[499]

The adjustment occurs in two phases as follows:

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[496] OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.8

[497] OECD, 2017, *Articles of The Model Convention with Respect to Taxes on Income and on Capital,* OECD, viewed 23 September 2019, from https://www.oecd.org/ctp/treaties/articles-model-tax-convention-2017.pdf on pg.8

[498] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.6

[499] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2111

10.1 Primary adjustment

The primary adjustment will be necessary for the following transactions related to intellectual property:

- When the royalty amounts that are declared are significantly lower that the actual royalty amounts which were received.[500]
- When the premium amount paid at the inception of the licensing agreement is greater than the market-related amount.[501]
- When an abnormal amount is charged for the purchase of intellectual property from a foreign connected person.[502]
- Where the intellectual property is sold by the South African subsidiary or parent to a foreign connected person at a price which is below the market-related value.[503]

An adjustment would then occur by calculating the difference between the amount that should have been declared (based on the price charged between unrelated persons) and the amount that was declared and this amount will be included in the taxpayer's taxable income.[504]

10.2 Secondary adjustment

If the person who gained from the tax benefit is a company, it will be deemed that the company declared a dividend in specie.[505] As such, the dividends tax at 20%, should be calculated on the tax benefit that was obtained.[506] If the person is not a company, it will be deemed that the person made a donation to the other connected person.[507] As such, donations tax at either 20% or 25% will have to be calculated on the tax benefit.[508]

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[500] S&Z Attorneys, 2007, *'Beware those transfer pricing contraventions'*, S&Z Attorneys, viewed on 17 June 2022, available from https://snz.co.za/articles/taxation/beware-those-transfer-pricing-contraventions/ on para.5-7

[501] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2111-2112

[502] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2111-2112

[503] S&Z Attorneys, 2007, *'Beware those transfer pricing contraventions'*, S&Z Attorneys, viewed on 17 June 2022, available from https://snz.co.za/articles/taxation/beware-those-transfer-pricing-contraventions/ on para.4

[504] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2111-2112

[505] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2111-2112; s 31(3) of the ITA

[506] Section 31(3) of the ITA and s 64E(1)(a)(i) of the ITA (rate for dividends tax)

[507] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2111-2112; s 31(3) of the ITA

[508] Section 31(3) of the ITA; s 64(1)(a)(i) of the ITA donations tax rate of 20% if the value of donation is R30 million and less; s 64(1)(a)(ii) of the ITA donations tax rate applied to an amount above R30 million

The OECD BEPS Action Plan was created as guidelines for enhancing the existing tax legislation which will ensure that the governments are provided with adequate taxing rights.[509] Action 8 of the OECD BEPS Action Plan was created as a guideline to align the transfer pricing methods for intellectual property.[510] Base erosion and profit shifting occurs when a multinational company deliberately seeks to shift the profits to a low-tax jurisdiction by either setting up an office there (but it will not be actively involved in generating income for the business), or adjusting prices in such a way that the market values of the transactions are not disclosed so that an extensive tax benefit is derived from these jurisdictions.[511] Applying arm's length in comparing the legitimacy of the intangible assets' prices can be challenging due to the fact that the intellectual property created by an organisation can be unique to an extent that they may not be comparable with what is available in the market.[512] A group of companies which consist of foreign connected persons may be assigned different aspects regarding the intellectual property, e.g., one company may own the intellectual property but another company may be responsible for settling the debt that could have been incurred for the creation of the intellectual property (such as patents and designs).[513]

Should an entity be subject to an audit, SARS will require documentary evidence which includes policies drafted regarding the pricing of the intellectual property, the analysis of the expertise and resources used for creating and pricing the intellectual property, as well as the risks anticipated, regarding the industry in which the entity and related entities operate.[514] Licensing agreements and agreements related to the cession of the ownership of intellectual property should be kept and updated which will form the evidence of the prices which were set regarding intellectual property transactions.[515] The foreign-related entity's pricing model

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[509] OECD, 2013, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, viewed 24 July 2020, from https://www.oecd.org/ctp/BEPSActionPlan.pdf on pg.11

[510] OECD, 2013, *Action Plan on Base Erosion and Profit Shifting*, OECD Publishing, viewed 24 July 2020, from https://www.oecd.org/ctp/BEPSActionPlan.pdf on pg.20

[511] Davis Tax Committee, n.d., *Davis Tax Committee: Second Interim Report on Base Erosion and Profit Shifting (BEPS) In South Africa: Introduction*, Davis Tax Committee, South Africa, viewed on 25 July 2021, from https://www.taxcom.org.za/docs/New_Folder3/2%20BEPS%20Final%20Report%20-%20Introductory%20Report.pdf on pg. 7

[512] OECD, 2015, *OECD/G20 Base Erosion and Profit Shifting Project Aligning Transfer Pricing Outcomes with Value Creation - Actions 8-10: 2015 Final Reports*, OECD, France, viewed 25 July 2021, from https://www.oecd-ilibrary.org/docserver/9789264241244-en.pdf?expires=1627220196&id=id&accname=guest&checksum=55B04B6772E55B980F3A88DEDB8639E1 on pg.74

[513] OECD, 2015, *OECD/G20 Base Erosion and Profit Shifting Project Aligning Transfer Pricing Outcomes with Value Creation - Actions 8-10: 2015 Final Reports*, OECD, France, viewed 25 July 2021, from https://www.oecd-ilibrary.org/docserver/9789264241244-en.pdf?expires=1627220196&id=id&accname=guest&checksum=55B04B6772E55B980F3A88DEDB8639E1 on pg.74

[514] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.24

[515] OECD, 2015, *OECD/G20 Base Erosion and Profit Shifting Project Aligning Transfer Pricing Outcomes with Value Creation - Actions 8-10: 2015 Final Reports*, OECD, France, viewed 25 July 2021, from https://www.oecd-

will have to be discussed in the instance where a direct transaction(s) were entered between the South African subsidiary or permanent establishment and the foreign-related entity and the South African related entity did not acquire intellectual property and has no distinctive operation.[516]

It is important that the cession of intellectual property to a connected person is motivated by commercial reasons and is not done for a tax benefit only.[517] One of the commercial reasons could be that intellectual property is used as a collateral in the process of securing debt.[518] It is imperative that the South African subsidiary or parent keeps a record of all the intellectual property and ensures that it has been priced correctly.[519]

It should be noted that the transfer pricing transactions may be subject to understatement penalties as contained in ss 221-223 of the Tax Administration Act.[520] This may also apply when the intellectual property has been sold off to a foreign connected person. In terms of the understatement as per s 221, a transfer pricing transaction would be considered an understatement because amounts declared in the return would have been substantially lower due to the number of transactions that are not at arm's length. If this is proven successfully by SARS, the difference between the tax that should have been calculated (based on arm's length transaction) and the actual tax that was paid would be subject to the understatement penalty.[521] The table in s 223[522] would be used by SARS in determining the behaviour that was exhibited through the lack of use of arm's length prices regarding intellectual property transactions. Furthermore, interest will be charged on the portion of the tax that was understated and the interest will be charged for each concluded month based on the prescribed rate, on the amount of tax that is still to be paid over to SARS.[523]

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ilibrary.org/docserver/9789264241244-en.pdf?expires=1627220196&id=id&accname=guest&checksum=55B04B6772E55B980F3A88DEDB8639E1 on pg.74

[516] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.25

[517] Visser, A., 2012, *'Companies Warned about Intellectual Property and Tax'*, SAIT, viewed on 17 June 2022, available from https://www.thesait.org.za/news/94443/Companies-warned-about-intellectual-property-and-tax.htm on para.2-4

[518] Visser, A., 2012, *'Companies Warned about Intellectual Property and Tax'*, SAIT, viewed on 17 June 2022, available from https://www.thesait.org.za/news/94443/Companies-warned-about-intellectual-property-and-tax.htm on para.6

[519] S&Z Attorneys, 2007, *'Beware those transfer pricing contraventions'*, S&Z Attorneys, viewed on 17 June 2022, available from https://snz.co.za/articles/taxation/beware-those-transfer-pricing-contraventions/ on para.8

[520] 28 of 2011

[521] In accordance with s 222 of the Tax Administration Act

[522] of the Tax Administration Act, 28 of 2011

[523] Section 89 of the Income Tax Act, 58 of 1962

The taxpayer should ensure that the amounts entered onto the ITR14 tax return should be at arm's length and there should be documentary evidence for the transfer prices determined.[524] SARS can elect to audit the current or previous years of assessment and hence it is necessary that the arm's length prices are utilised and that the necessary documentation is kept.[525]

10.3 Conclusion

Connected persons can engage in cross-border activities which involve intellectual property and this may result in the disproportionate transfer of profits to another jurisdiction.[526] A determination should be made on whether the parties have engaged in an 'affected transaction' and what tax benefit has arisen based on that transaction.[527] A primary and secondary adjustment should be performed once it has been established that an 'affected transaction' has been entered into.[528] The parties involved should draft pricing documents which will prove that the amount selected for an intragroup transaction represents an arm's length amount.[529] The parties may be expected to pay for the understatement penalties, which are levied under the Tax Administration Act, should it be found that income amounts (which result from cross-border transactions) were not declared at arm's length.[530]

[524] Ratombo, M. & Blumenthal, R., 2017, *The challenges faced by developing countries regarding transfer pricing*, Southern African Accounting Association Biennial International Conference Proceedings, Drakensberg, South Africa, 2017, p749-767, viewed 24 July 2020, from http://www.saaa.org.za/Downloads/Publications/TAX008%20The%20challenges%20faced%20by%20developing%20countries%20regarding%20transfer%20pricing.pdf on pg. 759

[525] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.7

[526] Ratombo, M. & Blumenthal, R., 2017, *The challenges faced by developing countries regarding transfer pricing*, Southern African Accounting Association Biennial International Conference Proceedings, Drakensberg, South Africa, 2017, p749-767, viewed 24 July 2020, from http://www.saaa.org.za/Downloads/Publications/TAX008%20The%20challenges%20faced%20by%20developing%20countries%20regarding%20transfer%20pricing.pdf on pg. 752

[527] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2111

[528] Section 31 of the ITA

[529] South African Revenue Service, 1999, *South African Revenue Service - Practice Note 7: Section 31 of the Income Tax Act, 1962 (The Act): Determination of The Taxable Income of Certain Persons from International Transactions: Transfer Pricing*, South African Revenue Service, South Africa, viewed on 26 March 2022, from https://www.sars.gov.za/wp-content/uploads/Legal/Notes/LAPD-IntR-PrN-2012-11-Income-Tax-Practice-Note-7-of-1999.pdf on pg.7

[530] Sections 221-223 of the Tax Administration Act, 28 of 2011

Chapter 11: Conclusion

The research report describes the different types of intellectual property. A brief discussion of the tax implications of the receipt and/or accruals of amounts related to the grant of the right to use the intellectual property were discussed.[531] Particular attention was given to the tax implications of the expense claims for intellectual property.

Key case law was referred to in the discussion as these cases contain principles to be considered when deciding whether an expense is of a capital or revenue nature.

Requirements of tainted intellectual property were discussed and it was established that the royalties paid would be denied a deduction under s 23I.[532] The taxpayer paying the withholding tax on royalties may qualify for relief on the royalty expenses if the withholding tax paid is at least 10%.[533]

Primary and secondary adjustments, in terms of s 31, will be made if it is found that royalty amounts which were paid were not valued at arm's length.[534] The premium amount paid, as well as the purchase amount of the intellectual property that was purchased from a connected person, which was not at arm's length, should also be subject to an adjustment.[535]

[531] Grant of 'right of use of intellectual property as per para(g)(iii) of the gross income as contained in s 1 of the ITA
[532] Section 23I of the ITA
[533] Section 23(I) of the ITA
[534] S&Z Attorneys, 2007, *'Beware those transfer pricing contraventions'*, S&Z Attorneys, viewed on 17 June 2022, available from https://snz.co.za/articles/taxation/beware-those-transfer-pricing-contraventions/ on para.5-7

[535] De Koker, A. & Williams, R.C., 2021, *Silke on South African Income Tax: Being an Exposition of the Law, Practice and Incidence of Income Tax in South Africa: Volume 1*, Lexis Nexis, South Africa on pg.2111-2112

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