BINDING PRIVATE RULING: BPR 285

DATE: 22 November 2017

ACT	**:**	**INCOME TAX ACT 58 OF 1962 (the Act)**
SECTION	**:**	**SECTION 11(*f*)**
SUBJECT	**:**	**INITIAL FEE PAID TO A FRANCHISOR**

1. Summary

This ruling determines the deductibility under section 11(*f*) of an initial lump sum payable in terms of a franchise agreement by a franchisee to a franchisor upon commencement of the franchise.

2. Relevant tax laws

This is a binding private ruling issued in accordance with section 78(1) and published in accordance with section 87(2) of the Tax Administration Act 28 of 2011.

In this ruling references to sections are to sections of the Act applicable as at 21 September 2017. Unless the context indicates otherwise any word or expression in this ruling bears the meaning ascribed to it in the Act.

This is a ruling on the interpretation and application of section 11(*f*).

3. Parties to the proposed transaction

The franchisee:	A company incorporated in and a resident of South Africa and the applicant
The franchisor:	A company incorporated in and a resident of South Africa

4. Description of the proposed transaction

The franchisee intends to open several franchised shops, with the necessary approval from the franchisor for every shop. If a shop is approved, the franchisee will enter into a franchise agreement with the franchisor. A person who wishes to become a franchisee, initiates an application process and if the franchisor is interested in considering the application, the would-be franchisee is afforded an opportunity to present a business plan for its approval. The franchisee is advised in writing that records that the initial fee is solely for the grant of the right to use the system, the system property and the marks of the franchisor and not for the franchisor's performance of any specific obligations or service. Services provided to the franchisee are charged for in addition.

The process to set up a shop further involves, amongst others, that the franchisee presents to the franchisor's investment committee, for that committee's approval, a document which includes information about the site, namely its location, feasibility studies performed, the business plan showing expected sales and rental and commercial terms, as well as the demographics of the area. Once that approval is obtained, the franchisee is permitted to develop the shop and obliged to do so within a specified time. The shop must be fitted out in accordance with the franchisor's detailed specifications. The shop may open for trading once it has been inspected by the franchisor.

In terms of the franchise agreement, the franchisor will grant to the franchisee the right to use the system, system property and marks of the franchisor, for the term of the franchise arrangement, solely for the purpose of operating the shop. The franchise agreement stipulates that –

- the marks, system property and associated goodwill will remain the exclusive property of the franchisor and the franchisee acquires no right, interest or benefit in it, other than the right of use granted under the agreement;
- the initial fee is not paid for the franchisor's performance of any specific obligations or services; and
- the franchisee does not enjoy any exclusive territory, protection or other right in the contiguous space, area or market.

The franchisee is required to pay the franchisor an upfront initial fee as well as a continuing fee for the right of use of the system, system property and marks. The initial fee is payable on or before the franchisor inspects the new shop and signs it off as ready for trading. If the application for a new shop is unsuccessful, no fee is payable in respect of the application for a new shop.

The system is primarily embodied in computer systems and a central database which contains data gathered daily by the franchisees and transmitted to the franchisor's specialised platform, where the data are processed. The franchisee is afforded limited and temporary access to the processed data, for forecasting and related operational purposes. A key feature of the use of the platform is the ability to forecast, typically on a half-hour forecasting horizon, how much of each product to prepare and how many staff to employ at various times of the day to meet customer demand and to manage the supply chain accordingly.

At the end of the term of the franchise arrangement the franchisee may renew the arrangement for a renewal term subject to meeting the conditions specified in the franchise agreement. Some of the conditions are beyond the control of the franchisee. Upon renewal, a renewal fee will be payable by the franchisee for the granting of the right to use the system, system property and marks for the renewal term.

5. Conditions and assumptions

This binding private ruling is not subject to any additional conditions and assumptions.

6. Ruling

The ruling made in connection with the proposed transaction is as follows:

a) The initial fee to be paid by the franchisee in terms of the franchise agreement is fully deductible in terms of section 11(*f*) over the term of the initial agreement.

b) The renewal fee to be paid by the franchisee in terms of the franchise agreement is fully deductible in terms of section 11(*f*) over the renewal term of the renewal agreement.

c) No view is expressed on the accuracy of the pricing of the initial fee that pertains to the intellectual property rights contemplated in sections 11(*f*)(iii) and the imparting or undertaking to impart any knowledge directly or indirectly related to such intellectual property rights as contemplated in section 11(*f*)(iv).

7. Period for which this ruling is valid

This binding private ruling is valid for a period of three years from 21 September 2017.

Legal Counsel: Advance Tax Rulings
SOUTH AFRICAN REVENUE SERVICE