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Claiming tax on tainted IP

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COMPANIES claiming income tax deductions on royalties paid for the use of intellectual property will have to reconsider their claims in the light of recent changes to the Income Tax Act.

Amendments to section 23I of the act now prohibit a South African taxpayer from claiming an income tax deduction for a royalty paid to another person if the intellectual property is tainted.

Intellectual property would be considered tainted if, for example, a South African taxpayer, including foreign company branches or other non-residents' permanent establishments, has sold the intellectual property (IP) to a foreign company but retained the right to use it to generate income in SA.

Royalties are also considered tainted if the IP is currently the property of a South African taxpaying resident (excluding certain tax exempt entities); or if the South African company that developed the IP, and any other closely connected local tax-paying resident either alone or together, hold at least 20% of the shares or voting rights in the foreign company to whom the royalty income accrues.

But all is not bad, and the legislation does provide some concessions. A royalty payable by one local company to another will be tax deductible in the hands of the payer because the royalty is not exempt from tax in the hands of the recipient company.

If the royalty is exempt in the hands of the recipient foreign company, but withholding tax of at least 10% was paid, the payer is permitted to claim a third of the royalty as a tax deduction. For example, if a South African company pays a royalty to a German company, the royalty is exempt from South African income tax in the German company's hands. But it is subject to a 12% withholding tax under section 35 of the Income Tax Act.

Therefore, the South African company is able to claim a third of the royalty expense as a tax deduction, despite the royalty being tainted.

If the IP is not tainted, the local company will be entitled to claim 100% of the royalty as a tax deduction, despite the withholding tax paid by the German company.

If the IP is tainted and no withholding tax was paid by the German company, the local entity will not be permitted to claim any income tax deduction.

Getting to grips with one month's notice

Samro case sheds some light on the obligations of employees when resigning

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MOST employers will have faced the situation of an employee resigning "with immediate effect", even though the contract of employment requires him or her to give notice.

The Basic Conditions of Employment Act provides that an employee's employment may be terminated only on notice of not less than four weeks where the employee has been employed for one year or more.

The employer and the employee may also agree to a longer notice period. This is often the case with senior employees, where notice periods of longer than one month are common. Notice periods also often refer to "calendar" months.

There are two important issues that arise in this context.

Firstly, what are the employee's obligations when giving notice in terms of his contract?

Secondly, what can the employer do if he breaches those obligations?

In the recent *Labour Court case of South African Music Rights Organisation Limited v Mphatsoe* (the Samro case), Mphatsoe was employed on a contract that required him to give written notice of one calendar month to terminate his employment.

He gave notice on January 8 2008 when he returned from leave. Samro contended that he could not leave at the end of January (as he initially wished to do) or on February 8 (when he conceded that he needed to give a month's notice). Instead, Samro argued that his month's notice would only start running from February 1 and end on February 29, because he was required to give a calendar month's notice.

Samro applied to the Labour Court for an order declaring that the notice given by Mphatsoe on January 8 was ineffective to terminate his employment; that the contract terminated on February 29; that he was in breach of contract when he left on February 8 and, as a result, Samro was entitled to damages.

To decide the case, the court had to consider two issues.

Firstly, what does giving a "calendar" month's notice mean?

Secondly, what damages can an employer claim from an employee who doesn't give proper notice and fails to work out his notice period?

What did the contract mean?

The court said that a "month", or a "calendar month", does not necessarily begin on the first day of the month and end on the last day of the month, as contended by Samro. It all depends on what was the intention of the parties when they concluded the employment contract. The rules for interpreting contracts (not the rules for interpreting statutes) must be applied.

Words used in a contract should not be interpreted in isolation, but in light of the contract as a whole. This means that where a word has been used elsewhere in the contract by the parties, the same meaning will be attributed to it throughout the contract. Where a word has been qualified in one context but used unqualified in other contexts, one must assume that the qualifier should be given significance.

Applying these principles to the Samro case, the court found that the unqualified word "month" appeared throughout the contract, other than the termination clause, whereas the words "calendar month" only appeared in the context of the notice period. The judge concluded that the parties obviously intended to qualify the word "month" in the context of giving notice.

By using the words "calendar month", the parties intended that notice should be given on the first day of the month to run until the last day of the month. In light of this finding, the court held that the employee had breached his employment contract.

The second question the court had to consider was whether Samro was entitled to damages, consequent to the breach of contract. Samro claimed damages equal to the value of the services that it alleged Mphatsoe would have provided over the period, which it equated to the remuneration which he would have earned for the period that he was in breach.

The court held that Samro failed to prove any damages suffered by it as a result of Mphatsoe having ceased work prematurely. There was no logical reason simply to assume that damages equated to the remuneration he would have earned over the notice period. The employer could have suffered damages exceeding that amount or, depending on the facts, it could have suffered no loss at all. In some circumstances, it might even have been to the employer's benefit to be relieved of having to pay the employee's salary. Because it had failed to establish any factual foundation on which a claim for damages could be based or any loss consequent on the employee's breach of contract, Samro's claim for damages was dismissed.

Therefore, although Samro was successful in part, in that the court found that the employee breached his contract of employment, Samro received no tangible relief as no damages were awarded to it.

The two issues of practical importance to employers arising from this case are as follows.

Firstly, employers should clearly stipulate what they mean by a "calendar" month's notice if that term is used when formulating employment contracts. In the event that an employee is required to give notice on the first day of the month to take effect on the last day of the month, it is advisable that this be stipulated in so many words in the employee's contract of employment. Secondly, before considering going to court to claim breach of contract, employers should be sure they have in fact suffered a loss and that they can prove the extent of the loss. Otherwise, the case will be an expensive exercise without any tangible reward.

> **Employers should clearly stipulate what they mean by a 'calendar' month's notice if that term is used when formulating employment contracts**

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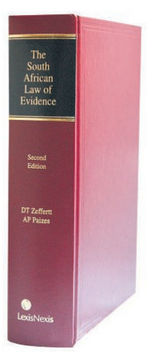

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