

# TAX & EXCHANGE CONTROL ALERT

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### FUTURE EXPENSES DEDUCTIBLE NOW – A JUDGMENT ABOUT SECTION 24C OF THE INCOME TAX ACT

Section 24C of the Income Tax Act, No 58 of 1962 (Act) provides for an allowance in respect of future expenditure to be incurred under a contract. On 3 November 2017, the Tax Court handed down its decision in *B v The Commissioner for the South African Revenue Services* (Case No: IT 14240) (as yet unreported). The case dealt with an appeal brought by B (Taxpayer) against the additional assessments raised by the South African Revenue Service (SARS). The taxpayer had claimed a s24C allowance during each of its 2011 to 2014 years of assessments, which allowance was disallowed by SARS.

# FUTURE EXPENSES DEDUCTIBLE NOW – A JUDGMENT ABOUT SECTION 24C OF THE INCOME TAX ACT

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## Facts

The Taxpayer was a franchisee, operating various chain restaurants under various franchise agreements between itself and the franchisor (Agreements). The terms of the Agreements are virtually identical. The Agreements required the franchisee to have as its main objective the operation of the restaurants, more specifically the sale of food to customers. The Taxpayer also had to pay a monthly franchise and service fee to the franchisor in respect of each of the restaurants operated by it. In terms of the Agreement, failure by the Taxpayer to actively operate the business would constitute breach of contract and would entitle the franchisor to cancel an agreement. The Agreements further obliged the Taxpayer to refurbish or upgrade the restaurants at reasonable intervals and the specifications in connection with such upgrades or refurbishments were subject to the franchisor's approval.

The Taxpayer claimed a s24C allowance in respect of future expenditure, that was to be incurred to finance the refurbishments or upgrades required by the Agreements.

## Issues to consider

With regard to s24C, the Tax Court indicated that there were two questions of law to consider:

- Firstly, whether the income received by the Taxpayer from operating its franchise businesses includes or consists of any amount received by or accruing to it in terms of the Agreements; and
- Secondly, whether the expenditure required to refurbish or upgrade is incurred by the taxpayer "in the performance of the taxpayer's obligations under such contract" as envisaged in s24C.

## Who's Who Legal

Emil Brincker has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory and Who's Who Legal: Corporate Tax – Controversy for 2017.

Mark Linington has been named a leading lawyer by Who's Who Legal: Corporate Tax – Advisory for 2017.

# FUTURE EXPENSES DEDUCTIBLE NOW – A JUDGMENT ABOUT SECTION 24C OF THE INCOME TAX ACT

CONTINUED

*The Taxpayer argued that the sale of food to customers was inextricably linked to the franchise agreement because the failure to do so would result in a breach of contract.*



## Judgment

A taxpayer can claim an allowance in terms of s24C, where the income received by a taxpayer under any contract will be used to finance future expenditure incurred in the fulfillment of the taxpayer's obligations under that contract.

The Taxpayer argued that the sale of food to customers was inextricably linked to the franchise agreement because the failure to do so would result in a breach of contract. As such, it argued that the sale of food did not constitute a contract separate from the one concluded between it and the franchisor. Furthermore, the Taxpayer argued that the expenditure incurred to refurbish or upgrade was unconditional, as the approval by the franchisor of the specifications of the refurbishments simply gave the franchisor control over what the refurbishments would look like, but did not affect whether they would have to be made or not.

SARS argued that there were two contracts. There was the franchise agreement, which creates the right for the taxpayer to establish and operate the restaurants under the franchise licence and trademark of the franchisor in exchange for the payment of franchise fees. SARS further argued that the day-to-day sales of meals

to customers by the Taxpayer constitutes a separate agreement. It also argued that the refurbishments were conditional as they were ultimately subject to the approval of the franchisor.

In interpreting s24C, the court made reference to, amongst other things, the explanatory memorandum setting out the rationale behind the introduction of s24C (Memorandum). The Memorandum states that s24C caters for the situation which often arises in the construction industry and sometimes in manufacturing concerns, where a large advance payment is made to a contractor before commencement of the contract work, to enable the contractor to purchase materials, equipment etc. The Memorandum notes that in a number of instances such advance payments are not matched by deductible expenditure, resulting in the full amounts of the payments being subjected to tax. The court also referred to Interpretation Note 78 (IN 78), which was published by SARS on 29 July 2014 and deals with the interpretation of s24C. IN 78 states, amongst other things, that although s24C "...was originally intended for taxpayers entering into building and manufacturing contracts, it does not mean that the section cannot be applied to taxpayers entering into other types of contracts." IN 78 envisages



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# FUTURE EXPENSES DEDUCTIBLE NOW – A JUDGMENT ABOUT SECTION 24C OF THE INCOME TAX ACT

CONTINUED

*The court concluded that the Taxpayer was entitled to the allowance under s24C for the 2011 to 2014 years of assessments.*



that s24C can be applied to businesses and industries other than building and manufacturing provided the detailed requirements of the section are met.

The court considered each franchise agreement as a whole and found that in terms of the Agreements, the franchisor exercised 'almost absolute control' over the franchisee. The extent of this control, by means of each franchise agreement, indicated that the sale of food was an integral component of the obligation placed on the Taxpayer under the same contract in terms of which the future expenses had to be incurred. As such, the income from the sale of food was derived from the franchise agreement. The court therefore ruled in favour of the Taxpayer on this issue and found that in each instance the franchise agreement and the contracts of sale of food were "inextricably linked" and constituted one contract in the context of s24C.

In dealing with the second issue referred to above, the court considered IN 78, which states that there must be a "high degree of probability and inevitability" that the taxpayer will incur the expenditure. A mere contingent liability will not be sufficient in this regard as a degree of certainty regarding the expenditure is necessary. The court noted that this determination is fact dependant and that there are no prescribed circumstances in which a taxpayer is guaranteed to succeed in proving the prescribed level of certainty.

The court relied on the following analogy in IN 78 to come to its conclusion:

Where a contractor is contractually obligated to build a house and tile the floors, the cost of the tiles will be included in the calculation of the future expenditure. The mere fact

that the client has not yet decided on the colour of the tiles does not detract from the certainty of the expense being incurred.

Similarly, the court held that the expenses to be incurred in making the refurbishments are sufficiently certain to warrant an allowance in terms of s24C, even though it is uncertain exactly what the refurbishments would look like. The franchisor's approval related to the precise manner in which the refurbishment obligation would be fulfilled, and not the actual fulfilment of the obligation by the Taxpayer.

The court concluded that the Taxpayer was entitled to the allowance under s24C for the 2011 to 2014 years of assessments.

## Comments

The judgment contains a thorough analysis of s24C and in that regard, sets out good and concrete principles, which must be taken into account when determining whether s24C can apply in an instance or not. From a practical perspective, the judgment is helpful not only to participants in the franchising industry, but in any industry where large advance payments need to be made to a party before actual contract work starts. In the challenging economic climate that South Africa is still facing, where we face many challenges to growth and the risks of starting a new business are high, it is important that a taxpayer should be able to claim the s24C allowance, where the taxpayer is entitled to it. If a taxpayer can claim the s24C allowance, it will reduce the taxpayer's tax liability in the early stages of its business, which would give it a better chance to survive and grow its business.

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