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TAX & EXCHANGE CONTROL ALERT

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Inextricably linked contracts? The Constitutional Court has the final say regarding section 24C of the Income Tax Act

On 21 July 2020, the Constitutional Court (CC) handed down judgment in *Big G Restaurants (Pty) Ltd v Commissioner for the South African Revenue Service* [2020] ZACC 16, which concerned section 24C of the Income Tax Act 58 of 1962 (Act). At issue before the CC was whether future expenditure incurred in terms of a franchise agreement was deductible against income derived by the taxpayer, Big G Restaurants (Pty) Ltd (Big G) from operating its franchise business.

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Inextricably linked contracts? The Constitutional Court has the final say regarding section 24C of the Income Tax Act

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On 21 July 2020, the Constitutional Court (CC) handed down judgment in *Big G Restaurants (Pty) Ltd v Commissioner for the South African Revenue Service* [2020] ZACC 16, which concerned section 24C of the Income Tax Act 58 of 1962 (Act). At issue before the CC was whether future expenditure incurred in terms of a franchise agreement was deductible against income derived by the taxpayer, Big G Restaurants (Pty) Ltd (Big G) from operating its franchise business.

In terms of section 24C of the Act, a taxpayer can claim an allowance in respect of future expenditure to be incurred, if certain requirements are met. The requirements are the following:

- Income must be received by or accrue to the taxpayer in terms of a contract;
- The income received or accruing to the taxpayer must be used in whole or in part to finance future expenditure which will be incurred by the taxpayer; and
- The expenditure must be incurred by the taxpayer in the performance of the taxpayer's obligations under such contract.

Background

Big G is a franchisee operating a number of Spur and Panarottis restaurants in terms of various written franchise agreements concluded with a franchisor, the Spur Group (Pty) Ltd (Spur Group). Big G claimed a section 24C(2) allowance for the 2011–2014 years of assessment

for the future costs of revamping its restaurant premises. The costs of revamping its premises were the direct result of a stipulation in the franchise agreements that Big G periodically revamp the premises.

Big G claimed the allowance on the basis that for purposes of section 24C(2), the income that it received from patrons in terms of individual contracts of sale, was income received in terms of the franchise agreements between it and the Spur Group. Therefore, it argued that the costs of revamping the premises constitute "future expenditure" as envisaged in section 24C of the Act. Future expenditure is defined as an amount of expenditure which will be incurred after the end of a year of assessment-

- in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment; or
- in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of this Act.

The Commissioner for the South African Revenue Service (SARS) disallowed the allowance claimed by Big G, on the basis that an allowance in terms of section 24C can only be claimed in respect of income that accrued in terms of the same contract that imposes the future expenditure for the allowance being claimed. The income in respect of which Big G was claiming the allowance was income that accrued in terms of contracts concluded by it with

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The Tax Court therefore concluded that Big G was entitled to claim the allowance under section 24C for the 2011-2014 years of assessments.

individual patrons at its restaurants and the future expenditure is not imposed by those contracts. SARS argued that the future expenditure was imposed by different contracts, these being the franchise agreements between Big G and the Spur Group.

Tax Court

The stated case before the Tax Court was that there were two questions of law to consider:

- firstly, whether the income received by Big G from operating its franchise businesses includes or consists of any amount received by or accruing to it in terms of the franchise agreements; and
- secondly, whether the expenditure required to refurbish, or upgrade is incurred by Big G in the performance of its obligations under such contract as envisaged in section 24C.

According to the Tax Court, the franchise agreements imposed an obligation on Big G to actively provide and sell meals to patrons and although the patrons were not

parties to those agreements, the proximate cause of those sales was this obligation.

It further held that the expenses to be incurred in making the refurbishments by Big G were sufficiently certain to warrant an allowance in terms of section 24C.

The Tax Court therefore concluded that Big G was entitled to claim the allowance under section 24C for the 2011-2014 years of assessments. We discuss the judgment of the Tax Court in our [Tax & Exchange Control Alert](#) of 2 March 2018.

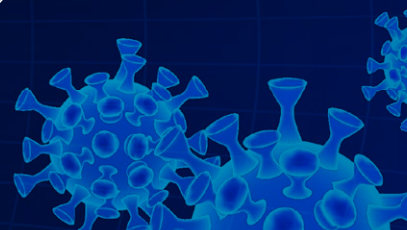
Supreme Court of Appeal

In the Supreme Court of Appeal, Big G conceded that it would not earn any income if it did not provide meals to patrons, but persisted with the contention that it was obliged to do so in terms of the franchise agreements, which was its source of income and which stated how it had to operate its restaurant.

The Supreme Court of Appeal rejected Big G's arguments and reasoned that the income was received as a result of the contracts Big G concluded with individual

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Inextricably linked contracts? The Constitutional Court has the final say regarding section 24C of the Income Tax Act...*continued*

According to the Supreme Court of Appeal, section 24C required Big G to incur expenditure in the performance of its obligations in terms of the same contract under which income is received.

patrons. Accordingly, it found that the income did not accrue to Big G in terms of the franchise agreements.

According to the Supreme Court of Appeal there is a direct and immediate connection between the requirements of section 24C, meaning that in order for Big G to claim the allowance, the income must be earned from the same contract in terms of which the obligations are incurred. The fact that the income and obligations must originate from the same contract, pointed to the conclusion that the allowance in section 24C was intended to apply to cases where income earned in terms of a contract is received before expenditure will be incurred to perform obligations under the same contract.

The Supreme Court of Appeal also rejected Big G's argument that the franchise agreement and the contracts with patrons were inextricably linked, and that both contracts required Big G to service meals to its patrons to earn income, out of which franchise fees were payable to the franchisor. According to the Supreme Court of Appeal, section 24C required Big G to incur expenditure in the performance of its obligations in terms of the same contract under which income is received. The operative concept according to the Supreme Court of Appeal was contract and not a scheme or transaction. We discuss the judgment of the Supreme Court of Appeal in our [Tax & Exchange Control Alert](#) of 7 December 2018.

Constitutional Court

On appeal in the CC, Big G argued that the matter turned on the interpretation of the words "*in terms of*" in section 24C, and this raised an arguable point of law of general public importance which ought to be considered by the CC.

The majority of the CC, per Madlanga J, agreed with Big G that the interpretative question was a quintessential point of law that engaged the jurisdiction of the CC. The CC held that the matter required the interpretation of the relevant contracts, so as to determine whether they were so interlinked as to fall within section 24C(2) and this in turn, required an interpretation of section 24C(2).

On the merits, Big G submitted that the countless contracts of sale of food are, and have to be read as, part of the franchise agreement. So read, the income earned in terms of the sale of food contracts is income earned in terms of the franchise agreement.

Big G also placed reliance on the judgment of the Tax Court, which held that the franchise agreement itself imposed an obligation on the franchisee to sell food, something which constitutes the sole business of the franchisee in terms of that agreement and therefore the income generated from the sale of those meals is as a result of that contract.

Inextricably linked contracts? The Constitutional Court has the final say regarding section 24C of the Income Tax Act...*continued*

Whereas the Supreme Court of Appeal rejected the argument that two separate contracts could be so inextricably linked as to meet the requirements of section 24C, it appears that the Constitutional Court accepted this argument.

According to the CC, under section 24C of the Act the contract in terms of which income is received or accrues (income-earning contract) must be the same contract that imposes the obligations, the performance of which are to be financed with that income (obligation-imposing contract). This to the CC demonstrated a requirement of "sameness". However, the CC did not read the sameness requirement in the section to connote that there must be one single contract stipulating for the earning of income and the imposition of future expenditure. Two or more contracts may be so inextricably linked that they may satisfy this requirement.

The CC was however, not satisfied that Big G had been able to place the contracts in terms of which it earns an income from its patrons within the ambit of the income-earning contract envisaged in section 24C. Furthermore, the obligations that Big G has to perform are imposed, not by the sale of food contracts, but by the franchise agreements. This lack of correlation between the income-earning contracts and obligation-imposing contracts plainly made section 24C inapplicable.

Furthermore, according to the CC, Big G was not without recourse as it would be entitled to a deduction in terms of section 11 of the Act. It is just that it will not be able to make an upfront deduction under section 24C.

In a separate concurrence, Majiedt J agreed with the outcome and order of the main judgment but disagreed on the finding that the matter engaged the jurisdiction of the CC. According to Majiedt J, It could not be that an enquiry into which of two contracts give rise to the income, or whether they can be regarded as a single contract for the purpose of interpreting the phrase "in terms of", amounts to a constitutional issue or an arguable point of law of general public importance.

Comment

There are two important issues that emerge from this judgment, the first being that from a practical perspective in order for a taxpayer to claim the allowance in terms of section 24C, there is a sameness requirement that it must satisfy.

The second issue is that whereas the Supreme Court of Appeal rejected the argument that two separate contracts could be so inextricably linked as to meet the requirements of section 24C, it appears that the CC accepted this argument. It reasoned that the requirements of section 24C did not preclude the existence of two or more contracts that may be so inextricably linked, under which circumstances the allowance could potentially be claimed. However, it seems that the CC left open the question regarding the degree to which two or more contracts had to be interlinked in order to satisfy the sameness requirement in section 24C.

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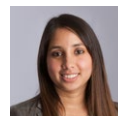
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