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TAX & EXCHANGE CONTROL ALERT

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IN THE END, THERE CAN BE ONLY ONE CONTRACT – THE SCA CONSIDERS SECTION 24C OF THE INCOME TAX ACT

On 3 December 2018, the Supreme Court of Appeal (SCA) handed down judgment in *CSARS v Big G Restaurants (Pty) Ltd* (157/18) [2018] ZASCA 179 (3 December 2018), concerning s24C of the Income Tax Act, No 58 of 1962 (Act).

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The Tax Court found that the Taxpayer's income was income earned for purposes of s24C under the same contract as that under which the Taxpayer's future expenditure would be incurred.

On 3 December 2018, the Supreme Court of Appeal (SCA) handed down judgment in *CSARS v Big G Restaurants (Pty) Ltd* (157/18) [2018] ZASCA 179 (3 December 2018), concerning s24C of the Income Tax Act, No 58 of 1962 (Act).

In terms of s24C of the Act, a taxpayer can, under certain circumstances, claim an allowance in respect of future expenditure incurred against income received by or accruing to a taxpayer, which income will be utilised wholly or partly to finance the future expenditure. The matter was initially heard by the Tax Court, which found in favour of Big G Restaurants (Pty) Ltd (Taxpayer). SARS appealed the Tax Court judgment to the SCA. We discussed the Tax Court judgment in our Tax & Exchange Control Alert of 2 March 2018.

Facts

The matter came before the Tax Court as a special case in terms of Rule 42 of the Tax Court's Rules read with Rule 33 of the Uniform Rules of Court. The agreed facts of the case were the following:

- The Taxpayer is a franchisee that operates restaurants in terms of various written franchise agreements with the franchisor, Spur Group (Pty) Ltd (Spur).
- The terms of the franchise agreements are virtually identical.
- A copy of one of those agreements was annexed to the special case (Franchise Agreement) and was considered to reflect the terms of all the agreements.
- In terms of the Franchise Agreement, the Taxpayer undertook that for the duration of the agreement, the main object and sole business carried on by it would be the operation of Spur Steak Ranch Restaurants and restaurants specialising in pizza and pasta, under the style of Panarottis.
- In terms of the Franchise Agreement, the Taxpayer had to pay Spur a monthly service fee and the Taxpayer was required to upgrade and/or refurbish its restaurants at reasonable intervals, as determined by Spur.
- In respect of its 2011 to 2014 years of assessment, the Taxpayer claimed certain amounts in terms of s24C of the Act in relation to future expenditure to be incurred, due to the obligation to upgrade and refurbish restaurants under the Franchise Agreement.

Questions of law and Tax Court decision

The Tax Court had to answer two questions:

- Firstly, whether income received by the Taxpayer from operating the franchise businesses, were amounts received or accrued in terms of the Franchise Agreement as envisaged in s24C of the Act;
- Secondly, whether the expenditure required to refurbish or upgrade restaurants was incurred 'in the performance of the taxpayer's obligations under such contract', as contemplated in s24C.

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The main issue in the appeal was whether the income received by the Taxpayer from operating its franchise business, included any amount received or accrued in terms of the Franchise Agreement, as envisaged in s24C of the Act.

The Tax Court found that the Taxpayer's income was income earned for purposes of s24C under the same contract as that under which the Taxpayer's future expenditure would be incurred. Consequently, it ordered that the additional assessments raised by SARS for the 2011 to 2014 years of assessment be set aside. The main issue in the appeal was whether the income received by the Taxpayer from operating its franchise business, included any amount received or accrued in terms of the Franchise Agreement, as envisaged in s24C of the Act.

Judgment

In terms of s24C(2) of the Act, future expenditure under a contract will be deductible, where *"...income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilised in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under such contract..."*

SARS argued that on any interpretation of s24C, the Taxpayer did not earn income from the Franchise Agreement and as such, could not claim the allowance under s24C. This is because the Taxpayer received income in terms of the *ad hoc* contracts concluded with patrons when meals were sold to them.

The Taxpayer conceded that it would not earn any income if it did not provide meals to patrons, but contended that it was obliged do so in terms of the Franchise Agreement, which was its source of income and stated how it had to operate its restaurants. Relying on the judgment in *Oosthuizen & Another v Standard Credit Corporation Ltd* 1993 (3) SA 891 (A), the Taxpayer argued that the phrase "in terms of" in s24C(2) of the Act should be given a wide meaning, namely that the Taxpayer's income was earned "pursuant to" or "in accordance with" the Franchise Agreement.

Relying on the judgment in *Slims (Pty) Ltd & Another v Morris NO* 1988 (1) SA 715 (A), the SCA held that the phrase "in terms of", has an ordinary (narrow) or wide meaning.

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In Oosthuizen, where the words were interpreted in the context of a lease agreement, it was held in the majority judgment that the wide meaning should apply.

In that case, the majority judgment held that the meaning of a word depends on the subject matter and context in which it appears. Elaborating on this issue, it explained that the word "kragtens" (the Afrikaans equivalent of "in terms of") is clearly capable of having different meanings. In the narrow sense, it can be used to denote a direct and immediate connection between the two concepts linked by it and in a wide sense, it may indicate no more than a loose and indirect relationship between the two concepts. In its wide meaning, the word is not confined to the designation of "a direct or exclusive connection between the two matters which it serves to link to each other".

In *Slims*, the majority judgment held that in the context of s37(5) of the Insolvency Act, No 24 of 1936, the wide meaning of "in terms of" should be preferred. In *Oosthuizen*, where the words were interpreted in the context of a lease agreement, it was held in the majority judgment that the wide meaning should apply.

The SCA then had to consider whether the wide meaning or ordinary meaning of "in terms of" applies in the context of s24C(2) of the Act. In the SCA's view, there is a direct and immediate connection between the requirements of s24C and that the Taxpayer must earn income from the same contract in terms of which obligations are incurred, to claim the allowance. The fact that the income and obligations must originate from the same contract, points to the conclusion that the allowance in s24C 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.

In the SCA's view the narrow meaning of "in terms of", is supported by the context and the background to the provision, which constitutes an exception to s23(e) of the Act. Section 23(e) states that no deduction shall be made in respect of income carried to any reserve fund or capitalised in any way. In terms of the Explanatory Memorandum to the Income Tax Act 104 of 1980 (Memorandum), which introduced s24C, the purpose of s24C was to address situations where a contract, typically a construction contract, provides for an advance payment to enable the recipient to finance the performance of its obligations under the contract (eg to purchase materials). The scenario in the Memorandum contemplates that the same contract creates the right to income and the obligation that has to be performed.

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The Taxpayer's income is derived from payments received from patrons as a direct result of food sold to them.

In applying the narrow meaning of "in terms of" to the current facts, the SCA held that the Taxpayer does not receive income under the Franchise Agreement. Instead, the Taxpayer earns income from contracts with patrons. The Taxpayer's income is derived from payments received from patrons as a direct result of food sold to them.

The SCA rejected the Taxpayer's argument that the Franchise Agreement and the contract(s) with patrons were inextricably linked, and that both contracts required the Taxpayer to service meals to its patrons to earn income, out of which franchise fees were payable to the franchisor. Its reason for rejecting the argument was that even though a contract is useful or even necessary to enable a taxpayer to earn income, it does not mean that its income is earned "in terms of" such contract. The court also noted that in *ITC 1667* (1999) 61 SATC 439 (C), a similar argument to the one made by the Taxpayer was rejected.

The SCA upheld the appeal with costs.

Comment

The practical importance of this judgment is that in order for a taxpayer to claim the allowance in terms of s24C, it must ensure that it earns income and incurs obligations under the same contract.

Therefore, where taxpayers anticipate a situation arising whereby they will earn income under a contract prior to incurring obligations or expenses, they must structure their affairs and agree with the counterparty that the obligations must be incurred under the same contract in terms of which income is earned. To ensure that they achieve the desired outcome and can legitimately claim the s24C allowance, taxpayers should always obtain proper legal advice before entering into the transaction.

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Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 2 BBBEE verification under the new BBBEE Codes of Good Practice. Our BBBEE verification is one of several components of our transformation strategy and we continue to seek ways of improving it in a meaningful manner.

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