6 DECEMBER 2019

TAX & EXCHANGE CONTROL **ALERT**

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Another ruling on income tax allowances for future expenditure

The court rejected the taxpayer's argument that the franchise contract and the contracts with patrons were inextricably linked.

Under section 24C of the Income Tax Act 58 of 1962, if a taxpayer receives income under a contract in a tax year, and if the income will be used to finance expenditure to be incurred by the taxpayer in future in the performance of its obligations under that contract – then the taxpayer may qualify for an allowance.

The provision has been the subject of two recent Supreme Court of Appeal (SCA) cases.

The first was *CSARS v Big G Restaurants (Pty) Ltd* (157/18) [2018] ZASCA 179 (3 December 2018) which was discussed in our Tax & Exchange Control Alert of 7 December 2018. In that case the taxpayer was a franchisee. It concluded franchise contracts which entitled it to operate restaurants. Under the contracts the taxpayer was obliged to upgrade the restaurants from time to time. The taxpayer claimed an allowance under section 24C for future expenditure to be incurred by it under the upgrading obligation.

The SCA ruled in favour of the Commissioner. The court held that two requirements must be met for the provision to apply. First, there must be income received or accrued in terms of a contract. Second, that income must be used to finance future expenditure which a taxpayer will incur in performing its obligations under that same contract. The SCA found that the taxpayer did not receive income from the franchise contracts; instead, it earned income from contracts with patrons for the sale of food.

The court rejected the taxpayer's argument that the franchise contract and the contracts with patrons were inextricably linked. It held that, even though a contract (such as a franchise 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" that contract.

The facts in the more recent case of *CSARS v Clicks Retailers (Pty) Ltd* (58/2019) [2019] ZASCA 187 (3 December 2019) were the following. The taxpayer, a retailer, ran a loyalty programme. Under that programme, the retailer issued cards to participants in the programme (members). The relationship between the retailer and the members was governed by the terms and conditions pertaining to the cards (Card Contract). Members earned points when they initially bought goods (First Purchase) from the retailer and presented their cards. If members earned enough points, they received vouchers which they could use as payment for future purchases (Second Purchase).

The retailer claimed an allowance under section 24C for expenditure it would incur to honour vouchers which participants would redeem in a subsequent tax year.

The taxpayer argued as follows. The Card Contract in itself created no claim for rewards. It was the First Purchase contract that brought the member's claim into existence and determined the content of the retailer's obligation to issue rewards. So, on each occasion that the retailer issued rewards, there was a "direct and immediate connection" between the retailer's obligation to do so and the First Purchase contract.

On the basis of the *Big G* judgment, Judge Dlodlo dismissed the notion that section 24C applies where there are different contracts but they are "inextricably linked". He held that the contract that created the

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right to income for the retailer was the First Purchase contract. However, the contract that obliged the retailer to honour the vouchers (and thereby to incur expenditure when a customer concluded the First Purchase contract with the retailer), was neither that contract, nor the Second Purchase contract – it was the Card Contract. Consequently, the expenditure incurred by the retailer in honouring the vouchers did not arise in terms of the same contract, i.e. the First Purchase and Second Purchase contracts, but in terms of the separate and distinct Card Contract.

In a separate but concurring judgment, Judge Wallis agreed with those principles. Wallis JA went on to state the following in relation to the purpose of section 24C (at pages 11 and 12 of his judgment):

> *"[24]...Most businesses recognise that they will be required in the ordinary course of their operations to incur future expenditure. An obvious example would be the need to make provision for the replacement of machinery and equipment in order to keep their operations up to date...The finance for such activities would have to be found from the ordinary stream of income of the business, or from borrowings. To permit an allowance for such future expenditure would result in future expenses being taken into account before they were incurred and afford taxpayers a means to manipulate the timing of tax payments. That was not the purpose of section 24C...*
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> *[26] The reason section 24C was introduced was not to afford a means whereby the taxpayer could take account of expenses foreseen but not yet incurred, but to alleviate the tax burden that would otherwise rest on builders and other taxpayers engaged in manufacturing businesses, where it is the practice to obtain a deposit or other payment in advance of work being undertaken...A problem arises where the deposit is paid in one year and the expenses in performing the contract are incurred in the following year. Absent s 24C the contractor would be obliged to declare and pay tax on the whole of the amount received in the first year and be left to set off against other income the expenses incurred in fulfilling the contract in the second year. In effect money paid to finance the performance of the contract would need to be diverted to the payment of tax, leaving the contractor to finance the performance of the contract from other resources. Permitting the taxpayer to deduct an allowance in respect of the cost of financing the performance of the contract in the second year restores the balance between income and expenditure."*

As an aside, the judge also said something interesting about the concept of expenditure. The expenditure of the retailer in this case was the cost of the stock which it acquired in the ordinary

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All taxpayers should ensure that they obtain advice before entering into contracts to establish whether or not the terms of the contracts will enable them to qualify for the section 24C allowance.

course of its business. It did not acquire stock specifically for purposes of the loyalty programme. Essentially, the court held that the retailer had no outlay; it was simply selling the stock at a discount to members much as it would do on stock clearance or "Black Friday" sales to ordinary customers.

The takeaways from the judgment are the following:

First, it neatly summarises the requirements that will need to be met if a taxpayer wishes to claim an allowance under section 24C:

1. A contract must be concluded under which revenue is received by the taxpayer.
2. The taxpayer must undertake obligations under that contract to be performed in the following tax year.
3. The performance of those obligations must oblige the taxpayer to incur expenditure in future.
4. The revenue received from the contract must be used to finance the performance of the taxpayer's obligations under the contract.

Second, all taxpayers should ensure that they obtain advice before entering into contracts to establish whether or not the terms of the contracts will enable them to qualify for the section 24C allowance.

Third, retailers (and other enterprises) should take extra care when they design and implement loyalty programmes to ensure that they are tax effective. (In fact, the same applies to other retail programmes such as the supply of gift cards – see, for example, *A Company v The Commissioner for the South African Revenue Service* (IT 24510) [ZATC] 1 (17 April 2019) discussed in our Tax & Exchange Control Alert of 26 April 2019.)

Ben Strauss

The picture is almost complete: Further regulations published regarding South Africa's carbon tax

On the South African front, we saw some important developments regarding carbon tax in South Africa.

While Greta Thunberg has caught the attention of many in recent times with her climate change activism, on the South African front, we saw some important developments regarding carbon tax in South Africa, specifically the following:

- On 29 November 2019, the Carbon Offset Regulations were published in the Government Gazette (Final Offset Regulations);
- On 2 December 2019, National Treasury (NT) published the Draft Regulations for the Trade Exposure Allowance (Draft Trade Exposure Regulations), for purposes of the trade exposure allowance catered for in section 10 of the Carbon Tax Act, No. 15 of 2019 (Act); and
- On 2 December 2019, National Treasury (NT) published the Draft Regulations for the Greenhouse Gas Emissions (GHG) Emissions Intensity Benchmarks (Draft Performance Allowance Regulations), for purposes of the performance allowance catered for in section 11 of the Act.

In this article, we briefly discuss the details of each of these regulations and how they will impact entities that will become liable for carbon tax under the Act.

Final Offset Regulations

The gazetting of the Carbon Offset Regulations follows a period of approximately three years since the publication of the initial draft regulations in 2016 (Initial Offset Regulations) and the publication of the amended draft regulations in 2018 (Amended Offset Regulations), which the public and stakeholders had the opportunity to comment on. We discussed the previous draft versions of the Carbon Offset Regulations in our Tax & Exchange Control Alert of 22 July 2016 and our Tax & Exchange Control Alert of 16 November 2018.

In our Tax & Exchange Control Alert of 16 November 2018, we compared the Initial Offset Regulations to the Amended Offset Regulations and the changes that had been made, with a particular focus on certain issues dealt with in the Amended Offset Regulations, including the –

- eligibility of a taxpayer to make use of the carbon offset allowance;
- offset utilisation period; and
- procedure for claiming the carbon offset allowance.

The Final Offset Regulations provide finality on these issues. When compared to the Amended Offset Regulations, some of the important amendments are the following:

- Regulations 2(2) and 2(3) of the Final Offset Regulations state that under certain circumstances, an offset in respect of an approved project in existence prior to 1 June 2019, constitutes an offset for the purpose of these Regulations and may be used for the offset utilisation period stipulated in regulation 3.

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The picture is almost complete: Further regulations published regarding South Africa's carbon tax

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Regulation 4 has also been amended to state that taxpayers conducting an activity in respect of a temporary CDM certified emission reduction, may also not receive the allowance in respect of an offset for that activity.

- Regulation 4(1)(b), which lists activities that cannot qualify for the carbon offset allowance, has been amended to state that a taxpayer conducting an activity in respect of renewable energy generated in respect of a technology with an installed capacity exceeding 15 Megawatt, with a cost equal to or lower than R1.09 per kilowatt hour may not receive the allowance in respect of an offset in respect of that activity;
- Regulation 4 has also been amended to state that taxpayers conducting an activity in respect of a temporary CDM certified emission reduction, may also not receive the allowance in respect of an offset for that activity. A "temporary CDM certified emission reduction" is defined in regulation 4 as a temporary certified emission reduction as defined in the United Nations Framework Convention on Climate Change, Clean Development Mechanism Glossary: CDM Terms.
- Regarding the certificate that is issued in terms of regulation 8 read with regulation 11, reflecting details of the approved project and the offset and which serves as proof thereof, there were two amendments. Regulation 11(h) now states that a certificate issued by the administrator as contemplated in regulation 8 must contain a statement that the certificate issued is not transferable. Regulation 11 further states that the certificate will indicate the tax period in which the certificate is issued.
- Lastly, regulation 13 states that the Final Offset Regulations are deemed to have come into effect on 1 June 2019 and therefore apply retrospectively.

Draft Trade Exposure Regulations

According to the document entitled "Summary – Draft Trade Exposure and GHG Emissions Intensity Benchmark Regulations", which was also released by NT on 2 December 2019 (Summary Document), some of the key features of the Draft Trade Exposure Regulations are the following:

- Regulation 2 provides for a list of sectors and the level of trade exposure allowance that each sector qualifies for, as specified in Annexure A of the Draft Trade Exposure Regulations. Annexure A provides a column of the SIC codes for each sector or subsector and the corresponding Intergovernmental Panel on Climate Change IPCC Code for different sectors;
- Regulation 3 provides that the carbon tax payable by a firm will be determined by a sum of the GHG emissions for each category, less the allowances for each emissions category (combustion, fugitive or industrial process). For companies with activities in different sectors with varying SIC code categories but within the same emissions category, and that potentially face different trade intensity risk levels simultaneously, a weighted average of the different tax-free allowance levels will be calculated; and
- Regulation 4 provides for taxpayers considered to be "borderline" and upon the request of such taxpayers, to use an alternative quantitative approach rather than a qualitative approach (considered to be inherently subjective in nature), for calculating the level of the trade exposure allowance.

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The Final Offset Regulations will apply retrospectively from 1 June 2019.

A taxpayer can qualify for a trade exposure allowance of up to 10%, depending on the sector(s) in which it operates. According to regulation 5 of the Draft Trade Exposure Regulations, it is intended that once the final version has been published in the Government Gazette, they will apply retrospectively from 1 June 2019.

Draft Performance Allowance Regulations

As stated in the Summary Document, section 11 of the Act sets out the formula to be used by taxpayers to determine the level of allowance that they would qualify for, which formula takes into account the actual emission intensity of the taxpayer for a certain tax period relative to an approved emission intensity benchmark factor. Pursuant to section 19(a) of the Act providing for the development of regulations to specify emission intensity benchmarks, these draft regulations outline the emission intensity benchmarks for sectors and subsectors.

According to the Summary Document, emissions intensity benchmark proposals were developed by industry associations for the following industries:

- liquid fuels;
- gas and coal to liquid fuels;
- mining;
- cement;
- iron and steel;
- paper and pulp;
- ferroalloys;
- titanium slag;
- chemicals (nitric acid);
- sugar; and
- clay brick.

According to the Summary Document, the setting of benchmarks was mainly based on the average emissions performance of a sector to ensure alignment with the benchmark approach adopted in many developing countries.

Regulation 2 provides for the sector GHG emission intensity benchmark values as set out in Annexure A to the Draft Performance Allowance Regulations to be used by taxpayers to calculate the performance allowance. Taxpayers can qualify for a performance allowance of up to 5%, to reduce their carbon tax liability. It is also intended that these regulations will apply retrospectively from 1 June 2019, once the final version is gazetted.

Observation

Although it is unfortunate that it took so long for each of the regulations to be published, at the very least, the Final Offset Regulations will apply retrospectively from 1 June 2019. If the Draft Trade Exposure Regulations and Draft Performance Allowance Regulations are gazetted in their current form without any changes, it appears that they will also apply retrospectively from 1 June 2019, which is the day on which the Act came into effect.

Hopefully, the Draft Trade Exposure Regulations and Draft Performance Allowance Regulations will be published before the end of June 2020, which is the date by which taxpayers must pay carbon tax due for the period ending 31 December 2019.

Louis Botha and Jessica Osmond

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BBBEE STATUS: LEVEL ONE CONTRIBUTOR

Cliffe Dekker Hofmeyr is very pleased to have achieved a Level 1 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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