SCHOOL OF ACCOUNTANCY

University of the Witwatersrand, Johannesburg

A PRACTICAL APPROACH TO SECTION 24C ALLOWANCES IN FUTURE EXPENDITURE ON CONTRACTS

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ABSTRACT

Section 24C of the South African Income Tax Act 58 of 1962 allows for a deduction against a taxpayer's income, where the income was received under a contract and the taxpayer, in fulfilling that contract, would be required to finance future expenditure.

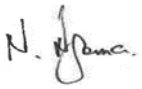
The purpose of the section is to match the revenue and expenditure within a specific tax year of assessment. Revenue received in advance is taxable when it is received however if the taxpayer is required to incur expenditure against that revenue, they can make use of the provisions of section 24C and get a deduction against that revenue for the future expenditure.

Recent court judgments suggest that taxpayers are incorrectly applying the provisions of section 24C. The courts have found in favour of the South African Revenue Service on at least two occasions recently. This study will look at the provisions of section 24C as well as the pitfalls that South African taxpayers ought to avoid when applying this section.

Key words: Revenue received in advance, future expenditure, contract, *BIG G*, *Clicks*, SARS, Interpretation Note no 78, IFRS 15, deposits, contractors, gross income

DECLARATION

I declare that this research report is my own unaided work. It is submitted for the degree of Master of Commerce at the University of the Witwatersrand, Johannesburg. It has not been submitted before for any other degree or examination at any other university.



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ABBREVIATIONS AND ACRONYMS

IASB	International Accounting Standard Board
IFRS	International Financial Reporting Standards
SARS	South African Revenue Service

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Chapter 1 – Introduction

1.1 - Introduction

The recent court judgments in the *Big G Restaurants (Pty) Limited v Commissioner for the South African Revenue Service* [2020] ZACC 16 as well as the judgment in *Commissioner for the South African Revenue Service v Clicks Retailers (Pty) Ltd* (58/2019) [2019] ZASCA 187 have shone a spot light in the manner in which taxpayers are applying the provisions of section 24C of the Income Tax Act 58 of 1962 (the Act).

In both cases, the taxpayers lost. This suggests that there are differences in interpretation between taxpayers and the South African Revenue Service (SARS). In 2014, SARS issued Interpretation Note: No. 78 – 29 July 2014 (Interpretation Note: No 78) in order to assist taxpayers with the correct interpretation of section 24C.

Section 24C is an allowance against income and taxpayers seem to be misinterpreting income items; when is something income and when is it not. This report will look at the recognition of revenue from an accounting perspective as per International Financial Reporting Standards as well as from a legislative point of view. Once this exercise has been completed, it should become much clearer to taxpayers whether they meet the provisions of section 24C.

In order to fully engage the practicalities of applying section 24C, we have to start with the legislation itself.

Section 24C of the Income Tax Act states;

> (1) For the purposes of this section, "future expenditure" in relation to any year of assessment means an amount of expenditure which will be incurred after the end of such year –
>
> (a) in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment; or
>
> (b) in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of this Act.
>
> (2) If the income of any taxpayer in any year of assessment includes or consists of an amount received under a contract and 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 the taxpayer's obligations under such contract, there shall be deducted in the determination of the taxpayer's taxable income for such year such allowance (not exceeding the said amount) in respect of so much of such future expenditure as relates to the said amount.

(3) The amount of any allowance deducted under subsection (2) in any year of assessment shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment.[1]

It has always been thought that the provisions of section 24C were introduced to specifically assist the engineering and construction industries against being taxed on income received in advance from projects where they still needed to incur future costs in order to fulfil the terms of those contracts.

In the construction sector construction companies invoice on a progress basis, where they would receive an initial deposit and thereafter would invoice at different stages of completion of such projects.

If one looks at how the legislation is drafted, it is quite clear that the legislators had the construction industry in mind when drafting the section.

Firstly, reference is made to future expenditure, a normal business that sells goods is unlikely to incur future expenditure, however; in the construction space it is common for companies to receive upfront deposits from which they will still need to incur material and other costs before they can actually complete a project. From an income tax point of view these deposits form part of gross income. Section 1 of the Income Tax Act defines gross income as follows; 'gross income, in relation to any year of assessment, means – (i) in the case any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident;...'[2]

This means the upfront deposits or the revenue received in advanced would be taxable in the year that it is received by the taxpayer.

To prevent a misalignment of income and expenses section 24C was introduced to align the expenditure to the income and thereby aligning the taxes as well. The calculation of the deduction is by formula. This seems to work quite well within the construction sector.

Secondly, section 24C states that such amounts should be received as per the terms of a contract, progress payments are generally pre agreed and the payments there-of are clearly identified in the construction contract.

[1] Section 24C of the Income Tax Act
[2] Section 1 of the Income Tax Act

Section 24C was introduced to provide relief to taxpayers by matching their income and expenses within each tax year of assessment where contracts ran over a number of tax years.

This brings into question whether other taxpayers who are not in these industries could also be eligible to claim a section 24C allowance.

The research report will review whether other entity types other than those involved in the construction industry are permitted to claim a section 24C deduction. An analysis of relevant case law will be conducted to this end.

This research report will also look at the South African business landscape and examine the pitfalls that taxpayers should avoid when claiming a section 24C allowance. The focus will be on the two big South African cases on section 24C. A review of these cases will be conducted in chapter 4 of the research report.

1.2 - The Statement Problem

The purpose of this research report is to deal with the statement problem as well as the sub problems.

The statement problem

Recent court judgments suggest that South African companies are unable to correctly apply the provisions of section 24C. This research report will look into the practicalities as well as the application of section 24C within the South African business landscape.

The sub-problems

- What are the key features and triggers that should be present for section 24C to apply? This first sub-problem will evaluate these triggers both in law and accounting. There seems to be confusion between what accounting principles consider revenue versus how tax law recognises revenue
- The research report will consider whether the provisions of section 24C are applicable to all entity types. It has been mentioned that section 24C was drafted with specific emphasis on the construction sector. Is it only applicable to this sector? There is case law that suggests that this may not necessarily be the case.

- What are the requirements for a valid section 24C deduction? Companies have been recently found wanting in the courts where they have misinterpreted the provisions of section 24C. The research report will look at the legal requirements as per section 24C as well as what SARS would consider a valid deduction under this section. SARS has issued an interpretation note – Interpretation Note: No. 78 – 29 July 2014 - to assist taxpayers to this end.
- The research report will also analyse the pitfalls by South African companies in their application of section 24C. What should companies avoid when claiming a section 24C allowance? An in depth analysis of the two recent court judgments will be performed to highlight how the courts will interpret section 24C claims.

1.3 - Chapter outline

The chapters of the research report will be outlined as follows;

Chapter 1: Introduction

This chapter will introduce the topic and provide some background on what has prompted the research on this particular topic. It will also deal with the problem and sub-problems as well as the structure of research report.

Chapter 2: What are the provisions of section 24C?

This chapter will look at the provisions of section 24C as currently legislated. It will further analyse SARS Interpretation Note: No. 78 – 29 July 2014 in relation to the application of the provisions of section 24C.

Chapter 3: Requirements for a valid section 24C deduction.

This chapter will focus on what constitutes a valid section 24C deduction. It will look at relevant case law and consider SARS view through an analysis of Interpretation Note: No 78 – 29 July 2014. SARS has also released a draft interpretation note - Draft Interpretation Note: Taxation of the Receipts of Deposits - 23 July 2020. Even though this is still in draft, it might provide some insight into how SARS intends to treat certain transactions; e.g. deposits.

Chapter 4: Pitfalls by taxpayers in their application of section 24C

This chapter will look at the judgments from the recent Clicks and BIG G cases and analyse how the taxpayers had misinterpreted the provisions of section 24C. A further analysis into the pitfalls that other taxpayers should look out for when applying the provisions of section 24C will be conducted.

Chapter 5: Conclusion

This chapter will conclude the topic by summarising the findings from the earlier chapters.

1.4 - Research methodology

This research report is a literature review, the information required to answer the problem statement and sub-problems will be sourced from books, South African Case Law, Articles as well as applicable Statutes.

Chapter 2 – What are the provisions of section 24C?

Section 24C is quite a short section in the Income Tax Act, it is titled 'Allowance in respect of future expenditure on contracts' and it states;

> (1) For the purposes of this section, "future expenditure" in relation to any year of assessment means an amount of expenditure which will be incurred after the end of such year –
>
> (a) in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment; or
>
> (b) in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of this Act.
>
> (2) If the income of any taxpayer in any year of assessment includes or consists of an amount received under a contract and 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 the taxpayer's obligations under such contract, there shall be deducted in the determination of the taxpayer's taxable income for such year such allowance (not exceeding the said amount) in respect of so much of such future expenditure as relates to the said amount.
>
> (3) The amount of any allowance deducted under subsection (2) in any year of assessment shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment.[3]

Section 24C(2) makes it clear that income has to have been received by the taxpayer in a year of assessment.

We will start by dissecting this part of the section by looking at the main drivers of income or revenue received in advance; both the accounting treatment of revenue from an IFRS point view as well as the tax treatment based on applicable tax legislation.

SARS Interpretation note: No. 78 introduces this topic as follows 'The nature of a taxpayer's business may be such that the taxpayer receives amounts under a contract that will be used to finance expenditure to be incurred in future in performing under that contract. An anomaly arises when the income is received in one year and the expenditure is incurred in a subsequent year of assessment.'[4]

The fact that the revenue is received in one year before the taxpayer has performed in terms of the contract suggests that there is an element of revenue received in advance. Would the revenue

[3] Section 24C of the Income Tax Act
[4] SARS Interpretation Note: No. 78 – 29 July 2014, Allowance for Future Expenditure on Contracts, at paragraph 2

received in advance be taxable? The interpretation note suggests that this will indeed be the case. It states that in the absence of section 24C this revenue received in advance would be taxable in the year when it is received.

The question that follows then is, why is revenue received in advanced taxable when there has not been any performance under a contract?

To examine this, we will need to consider the treatment of revenue received in advanced for both accounting and tax. This is where taxpayers often get it wrong, when the accounting records are being prepared typically using the International Financial Reporting Standards, revenue received in advance is treated in a specific manner, which differs from the tax treatment.

2.1 - Income Received in Advance – Accounting Treatment

In practice when tax computations are being prepared the starting point is usually the financial records, specifically the profit before tax. It is necessary to understand the accounting treatment of income received in advance from an accounting point of view so that taxpayers are able to correctly account for this revenue for tax purposes after having understood both treatments.

IFRS 15 - Revenue from contracts with customers - was issued in May 2014 and applies to annual reporting periods beginning on or after 1 January 2018. IFRS 15 specifies how revenue from contracts with customers should be recognised and accounted for in the financial records.

The purpose of IFRS 15 is to, 'establish the principles that an entity shall apply to report useful information to users of financial statements about the nature, amount, timing, and uncertainty of revenue and cash flows arising from a contract with a customer.'[5]

IFRS 15 applies to all contracts with customers except in instances where a contract with a customer is only partially within the scope of IFRS 15 and is partially with another standard. These would include leases within the scope of IAS17 (Leases); financial instruments and other contractual rights or obligations within the scope of IFRS 9 (Financial Instruments), IFRS 10 (Consolidated Financial Statements), IFRS 11 (Joint Ventures); insurance contracts with the scope of IFRS 4 (Insurance Contracts); and non-monetary exchanges between entities in the same line of business to facilitate sales to customers or potential customers. In such instances if the other

[5] IASB and FASB IFRS 15, Revenue from Contracts with Customers, 28 May 2014 Available at: https://www.iasplus.com/en/news/2014/05/ifrs-15 [Accessed on 07 March 2021]

standards specify how to separate and/or initially measure one or more parts of the contract, then those separation and measurement requirements are applied first. The transaction price will then be reduced by the amounts that are initially measured under other standards. If no other standard provides guidance on how to separate and/or initially measure one or more parts of the contract, then IFRS 15 will be applied.

The main terms in IFRS 15 are defined as follows;

Contract	An agreement between two or more people that creates enforceable rights and obligations.
Customer	A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.
Income	Increases in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities that result in an increase in equity, other than those relating to contributions from equity participants.
Performance obligation	A promise in a contract with a customer to transfer to the customer either: A good or a service (or a bundle of goods or services) that is distinct or A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer,
Revenue	Income arising in the course of an entity's ordinary activities.
Transaction price	The amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties.

Accounting requirements for revenue

IFRS 15 uses a five-step model for entity's to recognise revenue in order to depict the transfer of promised goods and services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods and services.

- Identify the contract(s) with a customer
- Identity the performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations in the contract
- Recognise the revenue when (or as) the entity satisfies a performance obligation.

Step 1 - Identify the contract with the customer

A contract with a customer will be within the scope of IFRS 15 if all the following conditions are met:

- the contract has been approved by the parties
- each party's rights in relation to the goods and services to be transferred can be identified;
- the payment terms for the goods or services to be transferred can be identified
- the contract has commercial substance; and
- it is probable that the consideration to which the entity is entitled to in exchange for the goods or services will be collected.

In instances where a contract with a customer does not yet meet all the requirements as per the above criteria then the entity is required to assess the contract going forward to determine whether it subsequently meets the criteria and from that point the entity will apply IFRS 15 to the contract.

The standard also provides detailed guidance on how to account for approved contract modifications. If certain conditions are met, a contract modification will be accounted for as a separate contract with the customer. If not, it will be accounted for by modifying the accounting for the current contract with the customer. The standards provides further details on how entities should account for modified contracts.

Step 2 – Identify the performance obligations in the contract

At the inception of the contract, the entity should assess the goods or services that have been promised to the customer, and identify as a performance obligation:

- a good or service (or bundle of goods and services) that are distinct; or
- a series of distinct good or services that are substantially the same and that have the same pattern of transfer to the customer.

A series of goods and services is transferred to the customer in the same pattern when both these requirements are met;

- each distinct good or service in the series that the entity promises to transfer consecutively to the customer would be a performance obligation that is satisfied over time (see below); and
- a single method of measuring progress would be used to measure the entity's progress towards complete satisfaction of the performance obligation to transfer each distinct good or service in the series to the customer.

A good or a service is distinct if is distinct if both the below requirements are met:

- the customer can benefit from the good or services on its own or in conjunction with other readily available resources; and
- the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.
- The following factors need to be taken into consideration when determining whether a promise to transfer goods or services to the customer is not separately include but are not limited to the following:
- the entity does provide a significant service of integrating the goods or services with other goods or services promised in the contract;
- the goods or services significantly modify or customise other goods or services promised in the contract;
- the goods or services are highly interrelated or highly interdependent.

Step 3 – Determine the transaction price

IFRS 15 defines the transaction price as the amount to which an entity expects to be entitled in exchange for the transfer of goods and services. When making this determination, an entity will consider past customary business practices.

Where a contract contains elements of variable consideration, the entity will estimate the amount of variable consideration to which it will be entitled under the contract. Variable consideration can arise, for example, as a result of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties or other similar items. Variable consideration is also present if an entity's right to consideration is contingent on the occurrence of a future event.

The standard deals with the uncertainty relating to variable consideration by limiting the amount of variable consideration that can be recognised. Specifically, variable consideration is only included in the transaction price if, and to the extent that, it is highly probable that its inclusion will not result in a significant revenue reversal in the future when the uncertainty has been subsequently resolved.

However, a different, more restrictive approach is applied in respect of sales or usage-based royalty revenue arising from licences of intellectual property. Such revenue is recognised only when the underlying sales or usage occur.

Step 4 – Allocate the transaction price to the performance obligations in the contracts

Where a contract has multiple performance obligations, an entity will allocate the transaction price to the performance obligations in the contract by reference to their relative standalone selling prices. If a standalone selling price is not directly observable, the entity will need to estimate it. IFRS 15 suggests various methods that might be used, including:

- Adjusted market assessment approach
- Expected cost plus a margin approach
- Residual approach (only permissible in limited circumstances).

Any overall discount compared to the aggregate of standalone selling prices is allocated between performance obligations on a relative standalone selling price basis. In certain circumstances, it may be appropriate to allocate such a discount to some but not all of the performance obligations.

Where consideration is paid in advance or in arrears, the entity will need to consider whether the contract includes a significant financing arrangement and, if so, adjust for the time value of money. A practical expedient is available where the interval between transfer of the promised goods or services and payment by the customer is expected to be less than 12 months.

Step 5 - Recognise revenue when (or as) the entity satisfies a performance obligation

Revenue is recognised as control is passed, either over time or at a point in time.

Control of an asset is defined as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. This includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. The benefits related to the asset are the potential cash flows that may be obtained directly or indirectly. These include, but are not limited to:

- using the asset to produce goods or provide services;
- using the asset to enhance the value of other assets;
- using the asset to settle liabilities or to reduce expenses;
- selling or exchanging the asset;
- pledging the asset to secure a loan; and holding the asset.

An entity recognises revenue over time if one of the following criteria is met:

- the customer simultaneously receives and consumes all of the benefits provided by the entity as the entity performs;
- the entity's performance creates or enhances an asset that the customer controls as the asset is created; or
- the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

If an entity does not satisfy its performance obligation over time, it satisfies it at a point in time. Revenue will therefore be recognised when control is passed at a certain point in time. Factors that may indicate the point in time at which control passes include, but are not limited to:

- the entity has a present right to payment for the asset;
- the customer has legal title to the asset;
- the entity has transferred physical possession of the asset;
- the customer has the significant risks and rewards related to the ownership of the asset; and
- the customer has accepted the asset.

Presentation in financial statements

Contracts with customers should be presented as either a contract liability, contract asset or a receivable in the statement of financial position.

A contract liability arises when a customer has paid an amount of consideration prior to the entity performing.

A contract asset or receivable is presented when an entity has performed, i.e. has transferred the goods or services but has not yet been paid the related consideration.

The accounting treatment of revenue received in advanced in terms of IFRS 15 is quite ground breaking as it seeks to simplify the accounting treatment in a standardised manner.

Since the Annual Financial Statements for listed entities are available to the public, the below extracts have been obtained from Murray and Roberts' 2020 Annual Financial Statements.

Murray and Roberts was chosen because it is a listed construction company. Construction companies work on large projects and their billing methods are suited to them having to claim section 24C allowances. They generally receive upfront deposits for construction work and in the absence of section 24C they would be liable for tax on these deposits. Section 24C grants relief to these entities by matching their income and expenses.

Murray and Roberts' revenue note, note 1.22, states the following:

> The Group applies IFRS 15: Revenue from Contracts with Customers.
>
> IFRS 15:56 states that variable consideration should only be included in the transaction price, when recognising revenue, to the extent that it is highly probable that a significant reversal will not occur when the uncertainty associated with the variable consideration is subsequently resolved.
>
> IFRS 5 defines "highly probable" as "significantly more likely than probable", where "probable" means "more likely than not" (IFRS 5: Appendix A).
>
> Due to the higher threshold required for recognition and measurement purposes, the application of IFRS 15 has resulted in the delayed recognition of variable consideration until such time that it is highly probable that the revenue will not be reversed when the uncertainty is resolved.
>
> The Group principally recognises revenue from construction contracts and rendering of engineering services to the natural resource market sectors.
>
> The Group applies the 5 step approach contained in IFRS 15 for determining when to recognise revenue, the amount that should be recognised and when revenue should be recognised.

Note 8 of the notes to the financial statements discloses contracts with customers. The revenue received in advance component is clearly disclosed as a liability – Amounts due to contract customers. This is in line with IFRS 15 disclosure requirements.

8 CONTRACTS-IN-PROGRESS AND CONTRACT RECEIVABLES

ALL AMOUNTS ARE EXPRESSED IN MILLIONS OF RANDS	2020	2019*
Contracts-in-progress (cost incurred plus recognised profits less recognised losses)	**1 816,9**	1 715,5
Uncertified claims and variations less payments received on account of R357 million (2019: R290 million)	**1 083,6**	637,1
Amounts receivable on contracts (net of impairment provisions)	**2 699,3**	2 571,2
Retentions receivable (net of impairment provisions)	**439,3**	251,5
	6 039,1	5 175,3
Amounts received in excess of work completed	**(3 543,2)**	(2 915,6)
Uncertified claims and variations included in amounts received in excess of work completed	**–**	95,7
	2 495,9	2 355,4
Disclosed as:		
Amounts due from contract customers	**6 039,1**	5 175,3
Amounts due to contract customers	**(3 543,2)**	(2 819,9)
	2 495,9	2 355,4

* *Restated for prior year measurement period adjustment. Refer to note 34.2 for further details.*

The amounts received in excess of work completed have increased predominantly due to an advance payment received on an Australian contract.

The Group utilises experts and probabilities when necessary in determining the amounts to be recognised relating to underclaims, uncertified revenue and contract debtors. The recoverability of amounts recognised are considered highly probable and as a result, the impairments recognised were not significant.

Update on the Group's claims processes

Uncertified revenue as at the end of the financial year increased to R1,1 billion (FY2019: R0,7 billion). The Group remains confident that all revenue recognised as uncertified will be certified and paid once attendant commercial matters have been resolved.

Figure: 1[6]

[6] http://www.murrob.com/pdf/investors/annual-integrated-reports/2020/7_Full_Annual_Financial_Statements.pdf, at page 40

The statement of financial position below clearly shows the assets and liabilities presented under note 8.

ALL AMOUNTS ARE EXPRESSED IN MILLIONS OF RANDS	Notes	2020	2019*
ASSETS			
Non-current assets			
Property, plant and equipment	2	**3 374,0**	2 203,4
Goodwill	3	**1 124,6**	958,8
Other intangible assets	4	**506,0**	474,9
Investment in joint ventures & associate companies	5 & 35	**76,4**	115,9
Other investments	6	**1 227,3**	1 436,7
Deferred taxation assets	20	**689,3**	421,7
Net investment in lease		**76,0**	–
Receivables		**19,9**	107,8
Total non-current assets		**7 093,5**	5 719,2
Current assets			
Inventories	7	**360,0**	337,2
Amounts due from contract customers	8	**6 039,1**	5 175,3
Trade and other receivables	9	**1 897,5**	1 668,7
Net investment in lease		**72,6**	–
Taxation assets	33	**20,9**	13,9
Cash and cash equivalents	10	**3 415,3**	3 455,0
Total current assets		**11 805,4**	10 650,1
Assets classified as held for sale	30	**–**	21,2
Total assets		**18 898,9**	16 390,5
EQUITY AND LIABILITIES			
Stated capital	11	**2 595,5**	2 593,7
Reserves	13 & 14	**1 620,5**	1 026,1
Retained earnings		**1 394,5**	2 096,8
Equity attributable to owners of Murray & Roberts Holdings Limited		**5 610,5**	5 716,6
Non-controlling interests	15	**8,2**	34,1
Total equity		**5 618,7**	5 750,7
Non-current liabilities			
Long term loans	17	**1 197,9**	1 127,4
Retirement benefit obligations	18	**13,5**	12,2
Long term provisions	19	**91,0**	80,1
Deferred taxation liabilities	20	**104,3**	74,4
Payables		**108,2**	129,2
Total non-current liabilities		**1 514,9**	1 423,3
Current liabilities			
Amounts due to contract customers	8	**3 543,2**	2 819,9
Trade and other payables	22	**4 273,9**	4 409,4
Short term loans	23	**1 213,1**	521,4
Taxation liabilities	33	**191,0**	134,9
Provisions for obligations	24	**238,8**	220,9
Subcontractor liabilities	21	**1 193,1**	1 074,5
Bank overdrafts	10	**1 111,3**	35,5
Derivative financial instruments		**0,9**	–
Total current liabilities		**11 765,3**	9 216,5
Total liabilities		**13 280,2**	10 639,8
Total equity and liabilities		**18 898,9**	16 390,5

Figure: 2[7]

[7] http://www.murrob.com/pdf/investors/annual-integrated-reports/2020/7_Full_Annual_Financial_Statements.pdf, at page 14

2.2 - Tax treatment of revenue received in advance

When we look at the tax treatment of revenue received in advance, the starting point should be the gross income definition. We will need to examine when and how revenue received in advance should be recognised for tax purposes.

Section 1 of the Income Tax Act defines gross income as follows;

> in relation to any year or period of assessment, means –
>
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
>
> (ii) in the case of any person other than a resident, the total amount, in cash or otherwise received by or accrued to or in favour of such person from a source within the republic,
>
> during such year or period of assessment, excluding receipts or accruals of a capital nature …

We will now look at the different parts of the definition and give meaning to the phrases.

Residence

The first part of the definition deals with residence.

Section 1 of the Income Tax Act in par (*b*) of the definition of a resident states that for persons who are not natural persons i.e. companies, close corporations and trusts, they will be considered to be resident if;

- the company close corporation and trust are incorporated, established and formed in the Republic or where the company, close corporation or trust has its place of effective management in the Republic.[8]

For the purpose of this report, we will assume that a South African resident company earns the revenue received in advance.

[8] Section 1 of the Income Tax Act

Total amount in cash, received by

For a taxpayer to be able to claim a section 24C allowance, in most instances and also for the purpose of this report, income needs to have been received prior to the taxpayer performing in terms of a contract. The receipt of income is therefore a requirement. For the purposes of section 24C this income needs to have been received in advance and the taxpayer would be required to incur expenditure in future against this income.

The income received will most likely be in cash and this will also be our assumption for the purposes of this report.

It is therefore established from the above, that for the purposes of section 24C, cash has to have been received and it should be quantifiable.

Does the fact that cash has been received mean that the amount should be included in gross income?

In *Geldenhuys v CIR*[9] the court had found that the fact that you've received an amount does not necessarily mean that it should be included in gross income.

The taxpayer in this case had had a usufructary interest in a flock of sheep. Her children were the owners of the sheep she merely enjoyed the fruits of the asset. The taxpayer and her children decided to give up farming and sold the sheep. The proceeds from the sale of the sheep were deposited into the taxpayer's bank account. The court found that the proceeds from the sale of the sheep belonged to her children. Since the number of sheep had declined from the usufruct had commenced there was no surplus that she could have been entitled to and therefore the full amount belonged to her children.

Even though the taxpayer had received the funds, since it was not for her own behalf and benefit it could therefore not be included in gross income.

[9] *Geldenhuys v CIR* 1974 (3) SA 256 (C); 14 SATC 419

In an instance where a taxpayer has received funds to use for the future acquisition of materials to enable to start project. Could he not argue on the basis that he was merely an agent and had received the funds to procure the materials on his client's behalf? The revenue authority is adamant that the receipt should be included in gross income and once it is then a section 24C allowance can be claimed against this income and this effectively provides the necessary relief.

The receipt of deposits also creates some confusion. There are tax payers who make use of returnable containers. The taxpayers in such cases only sell the product that is in the returnable container and would not necessarily sell the container that houses the product being sold, i.e. biscuits sold in returnable tins, beer, cold drinks and other beverages sold in returnable bottles.

Manufacturers would often charge a deposit fee for the returnable containers and when the customers return these in a reusable condition the deposits would be paid back to the customers. The question that arises is; should the deposit value received by the manufacturer be included in their gross income?

In *Pyott Ltd v CIR*[10] the court found that if the deposit amount received should be included in gross income. In this case the taxpayer was a biscuit manufacturer. The taxpayer would sell biscuits in tin containers and the taxpayer would charge a fee for the tin container, a deposit. The deposit would be refunded to the customer when the tin was returned in a good condition. At the end of the relevant year of assessment the taxpayer would deduct the deposit amounts from its gross income. The court was required to rule whether the amounts deducted by the taxpayer from gross income should be included in its gross income. The taxpayer had also conceded that the amounts received from the sale of the containers were not trust monies and if they had been the amounts would have been excluded from gross income.

Based on the above case law, deposits received from customers for returnable containers should be included in the taxpayer's gross income.

The question that arises now is, can these manufacturers claim a section 24C allowance against the revenue for future expenditure to be incurred in settlement of the deposit liabilities when the containers are subsequently returned by customers?

[10] *Pyott Ltd v Commissioner for Inland Revenue* 1945 AD 128, 13 SATC, 121

Theoretically, this should be allowed provided all the requirements of section 24C are met, we will look into this further in the next chapter when we deal with the requirements for valid section 24C claims.

Excluding receipts of a capital nature

Receipts of a capital nature are excluded from the gross income definition; however, this does not mean that receipts of a capital nature are completely exempt from tax. These are still subject to income tax and are brought back into the income tax formula as taxable capital gains.

If we accept that revenue received from the sale of the returnable containers constitute income, would this revenue not be capital in nature?

An asset from an accounting perspective is defined as present economic resource as a result of past events. An economic resource is a right that has the potential to produce economic benefits.[11]

Returnable containers are treated and classified as assets for financial reporting purposes. If the sale of biscuits and drinks means the returnable containers are also sold, should these sales not be treated as capital? If this were to happen, what would the tax consequences be?

Sales of returnable containers would be excluded from gross income on the basis that they are capital nature. They would however be brought back in the tax formula as capital gains. If we assume that a taxpayer paid R10 to acquire a returnable container but only takes a R2 deposit fee, then he would have made an accounting loss of R8 if assume that the taxpayer did not claim any accounting depreciation. The accounting loss is however of no tax consequence as it will be added back for tax purposes.

Let us assume a full wear and tear deduction for tax purposes, SARS grants a small items allowance for assets that cost less than R7,000 meaning the tax value would be R nil (R10 cost less R10 wear and tear).

[11] IASB, Revised Conceptual Framework, 29 March 2018 Available at: https://www.iasplus.com/en/news/2018/03/cf [Accessed on 07 March 2021], as summarised in Chapter 4

The taxpayer would then be required to prepare a capital gains calculation to calculate the amount that should be included in the tax formula. For the same selling price, equivalent to the deposit fee of R2, the taxpayer would recognise a recoupment in terms of section 8(4)(*a*) of the Income Tax Act of R2. There will therefore be no capital gain or loss, however the recoupment amount would have to be included in the taxable income of the taxpayer.

What we can conclude from the above is that the recoupment amount of R2 would be equivalent to the taxable deposit amount of R2, so the taxpayer would essentially be taxed the same amount whether the amount is included in gross income from the onset or whether it's treated as capital.

For the purposes of this report the deposit value for returnable containers will be treated in terms of the prevailing case law and will be included in gross income.

The prerequisite for a section 24C allowance is income, however the income needs to have been received in terms of a contract. We will therefore look at what constitutes a legal contract.

2.3 - Contracts

For taxpayers to claim a section 24C allowance the income must be received by or accrued to a taxpayer under a contract.

The term contract is not defined in the Income Tax Act.

SARS Interpretation Note: No. 78 gives it its ordinary meaning and defines it in terms of the Law of South Africa. A contract is, '[a]n agreement entered into with the intention of creating an obligation or obligations'.[12]

In *Commercial Law*[13] a contract is defined as an agreement (based on consensus between legal subjects with contractual capacity, and which is legal, physically possible and of complies with the prescribed formalities) reached with the intention of creating a legal obligation with resulting rights and duties.

Therefore, a contract is an agreement which gives rise to a legal obligation.

[12] SARS Interpretation Note: No. 78 – 29 July 2014, Allowance for Future Expenditure on Contracts, at paragraph 4.1.1

[13] Nagel, C.J., Boraine, A., Lötz, D.J., Otto, J.M., Prozesky, B., Roestoff, M., Theron. L., van Jaarsveld, S.R., (1995). *Commercial Law*. Johannesburg: Lex Patria, at paragraph 3.54

There are five requirements that should be met before a contract can be valid and these are;

- **consensus**: The basis of all contracts is the agreement between the parties, which must be based on consensus between the parties. The parties must have corresponding intentions regarding the proposed contract, combined with the serious intention of concluding the specific contract with its concomitant consequences.
- **contractual capacity**: The parties must have a the necessary legal capacity to be able to form a legally recognised will for the purposes of concluding a contract.
- **Legality**: The contract must be legal, and may not be contrary to the common law or any statutory rule of law.
- **Physical possibility**: the performance which must be delivered in terms of the contract, must at the time of conclusion of the contract be determined or determinable, as well as possible.
- **Formalities**: the contract must comply with the formalities prescribed by law or by the parties themselves. Formalities refer to the external visible form of the contract, for example formalities requiring the contract to be reduced to writing and to be signed by all the parties to the contract.[14]

There are further important key concepts that should also be understood regarding contracts. These are as follows;

The parties: Since there must be at least two corresponding wills for consensus to exist, it follows naturally that at least two or more parties must participate in the conclusion of a contract. A person cannot conclude a contract with himself. Parties participate in the various capacities of debtor(s) and creditor(s). It is possible for a party to simultaneously act as both debtor and creditor (he is entitled to claim performance from the other party, but is also at the same time obliged to deliver a counter performance).[15]

The performance: A certain performance (or more than one performance) must be delivered in terms of a contract. That to which the debtor binds himself is called his performance. Performance can consist of positive conduct (where the debtor must do, deliver or pay something), or negative

[14] Nagel, C.J., Boraine, A., Lötz, D.J., Otto, J.M., Prozesky, B., Roestoff, M., Theron. L., van Jaarsveld, S.R., (1995). Commercial Law. Johannesburg: Lex Patria, at paragraph 3.55
[15] at paragraph 3.56

conduct or an omission (such as not to do something, for example, not to do business in a certain area for a specific period).[16]

Unilateral contracts: Where only one of the parties acts in the capacity of debtor, and the other party only acts as creditor, the contract is unilateral one. Only one obligation is created between the parties in terms of which only one unilateral delivery of performance must be made. A donation is, for example is a unilateral contract, in terms of which the donor must deliver the donation, and the donee is entitled to receive the donation.[17]

Reciprocal contracts: Where the parties in the contract act in the capacities of both debtor and creditor (where each party is obliged to deliver a performance), a reciprocal contract is concluded. The parties are debtor and creditor of each other in turn. Most contracts encountered in the commercial world are of a reciprocal nature. In terms of a contract of sale, for example, the purchaser (debtor) must pay an amount to the seller (creditor), but the seller (debtor) must in return deliver the object the sold to the purchaser (creditor).[18]

Nominate contracts: A nominate contract is a type of contract which had occurred so often that it earned its own name, such as a contract of sale or a contract of lease. Every nominate contract can be classified according to its own typical essential minimum characteristics. These minimum characteristics are called the essentialia of the contract. The parties to the contract must reach consensus on at least the essentialia of that particular type of contract before the contract between them can be identified as a specific nominate contract. A contract of sale, for example, has three essentialia, namely the intention of the parties to purchase and sell, certainty regarding the object sold and certainty as regards the purchase price.[19]

Essentialia: The contents of a contract can be divided into three categories. The essential minimum characteristics which have to be contained in a contract in order to identify it as a certain specific nominate contract and to distinguish it from other nominate contracts, are called the essentialia of the contract. The remaining terms of a contract can be divided into naturalia and incidentalia.[20]

[16] at paragraph 3.57
[17] at paragraph 3.58
[18] at paragraph 3.59
[19] at paragraph 3.60
[20] at paragraph 3.61

Naturalia: Naturalia are those terms which naturally (automatically) and by operation of law from part of a contract, without the parties having specifically agreed to thereto, however, the parties may expressly agree to exclude some of the naturalia. An example of naturalia included in a contract of sale is the warranty against latent defects.[21]

Incidentalia: All other contractual terms are called incidentalia. These include all additional terms and conditions which the parties wish to include in the contract either expressly or tacitly. Naturalia can be excluded from a contract by using express incidentalia to that effect. The warranty against latent defects (naturalia) can be excluded from the contract by a 'voetstoots' clause.[22]

Contracts which are null and void: Where one or more of the requirements of a valid contract are absent, no contract and consequently no legal obligation can come into being. When a contract is said to be null and void it actually means that no contract has come into being.[23]

Voidable contracts: Where a contract did come into being, but it can be set aside because of some or other defect, it is called a voidable contract. The defect must have been present at the time of conclusion of the contract. Where the parties do reach consensus, but the consensus was obtained in some or other improper manner such as duress, such consensus can be assailed. The prejudiced party may however, choose to uphold the contract and is mot obliged to have it set aside. The contract then remains valid.[24]

Unenforceable contracts: Certain contracts create legal obligations, which are recognised but not enforceable by law. These obligations are called natural obligations (as opposed to civil obligations). The law will not assist the parties in enforcing the contract. The contract remains valid but unenforceable. Where parties conclude a wager, the law will acknowledge the contract (the law will, for example, recognise set-off), but no court order will be given to enable the parties to enforce the contract in any way.[25]

The above information provides a summarised background into the law of contract. This is quite useful in assisting taxpayers with regard to the legalities and terms of a contract. Once these are

[21] at paragraph 3.62
[22] at paragraph 3.63
[23] at paragraph 3.64
[24] at paragraph 3.65
[25] at paragraph 3.66

clearly understood it would make it almost impossible for the tax authority to disallow their section 24C claim based on the legality or validity contracts.

The next part will deal with the future expenditure component of the provision as well as the performance under a contract component. These are the key building blocks of section 24C.

2.4 - Future expenditure

Section 24C allows for a deduction for certain future expenditure that will be incurred by a taxpayer in the performance of his obligations under a contract from with he has received income.

The word 'expenditure' is not defined in the Income Tax Act. It is therefore often given its ordinary meaning.

We will examine the term from both an accounting as well as a tax point of view. This distinction between accounting and tax is quite important. Tax computations are prepared by tax practitioners who make use of financial information prepared by accountants, if the tax practitioner does not understand or is unable to interpret what the accountants have done, then the likelihood of error is increased.

Accounting treatment

Expenditure from accounting point of view is split into two parts, operating expenditure and capital expenditure.

The International Accounting Standards Board (IASB) has published its revised Conceptual Framework for financial reporting. The revised framework has included new definitions for some of the elements of financial statements.

An expense is now defined as decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions to holders of equity claims.[26]

[26]IASB, Revised Conceptual Framework, 29 March 2018 Available at: https://www.iasplus.com/en/news/2018/03/cf [Accessed on 07 March 2021], at summarised Chapter 4

An asset is defined as a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.[27]

Practically expenditure is incurred to acquire both an asset and to settle an expense. The difference lies in how these are recognised in the financial statements.

If an entity applies IFRS the recognition criteria of each of the elements would have to be met in order for these items to be correctly classified.

Capital expenditure will result in assets which should be recognised in the statement of financial position whilst operating expenditure will result in expenses which should be recognised in the statement of financial performance.

Tax treatment

Since the term is not defined, we will look at the relevant case law.

Interpretation note: No. 78 makes reference to the fact that Section 24C applies only to future expenditure and not losses and makes reference to a few cases on the distinction between the two, namely, the *Joffe & Co (Pty) Ltd V CIR*[28] matter where Watermayer CJ explained the distinction between the words 'loss' as follows;

> "In relation to trading operations the word [loss] is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money."

In *C: SARS v Labat Africa Ltd*[29] Harms AP noted the following;

> "[t]he term 'expenditure' is not defined in the Act and since it is an ordinary English word and, unless context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. … In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended".

[27] IASB, Revised Conceptual Framework, 29 March 2018 Available at: https://www.iasplus.com/en/news/2018/03/cf [Accessed on 07 March 2021], at summarised Chapter 4
[28] *Joffe & Co (Pty) Ltd V CIR* 1946 AD 157, 13 SATC 354 at 360
[29] *C: SARS v Labat Africa Ltd* 2013 (2) SA 33 (SCA), 74 SATC 1 at 6 (paragraph 12)

In *Ackermans Ltd v C: SARS*[30] the court was required to consider the meaning of 'expenditure incurred' in the context of contingent liabilities which had reduced the net purchase price. The taxpayer sold its retail business which included the business assets, the liabilities and the contracts as a going concern. The purchase price was defined as the amount equal to R800 million plus the rand amount of the liabilities. The purchase price was to be discharged by the purchaser assuming agreed liabilities (including contingent liabilities) and the creation of a loan account. The taxpayer claimed a section 11(*a*) deduction equal to the amount of the contingent liabilities on the basis that by foregoing a portion of the purchase price it had incurred expenditure equal to the amount of the contingent liabilities. Cloete JA disagreed, stating the following:[31]

> To my mind, 'expenditure incurred' means the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability. No liability was incurred by Ackermans to Pepkor in terms of the sale agreement. The manner in which the purchase price was discharged by Pepkor did not result in the discharge of any obligation owed by Ackermans to Pepkor. Ackermans owed Pepkor nothing in terms of the sale agreement and one looks in vain for a clause in that agreement that has this effect. ….
>
> It is clear that what occurred, as is usually the case in transactions of this nature, is that the nett asset value of the business - the assets less the liabilities - was calculated and that this valuation dictated the purchase price. In the ordinary course of purchasing the business as a going concern on this basis it would follow that the liabilities would be discharged by the purchaser. The journal entries relied on by the appellants do not equate to expenditure actually incurred. On the contrary, the mechanism employed in the agreement of sale resulting in the journal entries was to facilitate the sale.
>
> The fact that Ackermans rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, does not mean in fact or in law that it incurred expenditure to the extent that the purchase price was reduced by the liabilities. At the effective date no expenditure was actually incurred by Ackermans.

Section 24C(1)(*a*)[32] states 'in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment; or…'

The precondition is that the expenditure needs to be deductible in future this means the expenditure needs to meet the requirements of section 11(*a)* of the Income Tax Act.[33]

[30] *Ackermans Ltd v C: SARS* 2010 (1) SA 1 (SCA), 73 SATC 1
[31] At 5 and 6.
[32] Section 24C(1)(*a*) of the Income Tax Act
[33] Section 11(*a*) of the Income Tax Act

Section 11(*a*) states:

'For the purposes of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

(a) expenditure and losses actually incurred in the production of the income provided such expenditure and losses are not of a capital nature;…'

This also means that the requirements of section 23(*g*)[34] need to be met before the expenditure can be deducted.

Section 23(*g*) states that;

'No deductions shall in any case be made in respect of the following matters, namely – ….

(*g*) any money, claimed as deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for purposes of trade;..'

The case law points towards the fact that the future expenditure needs to be genuine expenditure for income tax purposes, i.e. it would need to meet the provisions of section 11(*a*) as well as section 23(*g*) for it to qualify as a deduction for section 24C purposes.

2.5 - Performance under a contract

Performance for accounting purposes

IFRS 15 lays down the rules of how and when performance should be measured.

IFRS 15 states the following:

> At contract inception, an entity shall assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either:
>
> (a) a good or service (or a bundle of goods or services) that is distinct; or
>
> (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer[35]

[34] Section 23(*g*) of the Income Tax Act

[35] IFRS 15, Revenue from Contracts with Customers, May 2014 Available at: http://old.efrag.org/files/EFRAG public letters/Revenue Recognition/IFRS_15.pdf [Accessed on 07 March 2021], at paragraph 22

A contract with a customer generally explicitly states the goods or services that an entity promises to transfer to a customer. However, the performance obligations identified in a contract with a customer may not be limited to the goods or services that are explicitly stated in that contract. This is because a contract with a customer may also include promises that are implied by an entity's customary business practices, published policies or specific statements if, at the time of entering into the contract, those promises create a valid expectation of the customer that the entity will transfer a good or service to the customer.[36]

Performance obligations do not include activities that an entity must undertake to fulfil a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.[37]

Satisfaction of performance obligations

An entity shall recognise revenue when (or as) the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when (or as) the customer obtains control of that asset.

An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognises revenue over time, if one of the following criteria is met:

(a) the customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs;

(b) the entity's performance creates or enhances an asset (for example, work in progress) that the customer controls as the asset is created or enhanced; or

(c) the entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.[38]

An asset created by an entity's performance does not have an alternative use to an entity if the entity is either restricted contractually from readily directing the asset for another use during the creation or enhancement of that asset or limited practically from readily directing the asset in its completed state for another use. The assessment of whether an asset has an alternative use to the entity is made at contract inception. After contract inception, an entity shall not update the assessment of the alternative use of an asset unless the parties to the contract approve a contract modification that substantively changes the performance obligation.[39]

An entity shall consider the terms of the contract, as well as any laws that apply to the contract, when evaluating whether it has an enforceable right to payment for performance completed to date in accordance with paragraph 35(c) of IFRS 15. The right to payment for performance completed to date does not need to be for a fixed amount. However, at all times throughout the duration of the contract, the entity must be entitled to an amount that at least compensates the entity for performance completed to date if the contract is terminated by the customer or another party for reasons other than the entity's failure to perform as promised.[40]

[36] at paragraph 24
[37] at paragraph 25
[38] at paragraph 35
[39] at paragraph 36
[40] at paragraph 37

Performance obligations satisfied at a point in time

It is important to note that in terms of IFRS 15, performance obligations can be satisfied at a point in time once the risks and rewards have been transferred to the customer. The assumption in such instances is that revenue will only be recognised at that point in time once the customer has control of the asset.

> ***Measuring progress towards complete satisfaction of a performance obligation***
>
> For each performance obligation satisfied over time in accordance with paragraphs 35–37, an entity shall recognise revenue over time by measuring the progress towards complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (ie the satisfaction of an entity's performance obligation).[41]
>
> An entity shall apply a single method of measuring progress for each performance obligation satisfied over time and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress towards complete satisfaction of a performance obligation satisfied over time.[42]

Performing under a contract, therefore, from an accounting perspective means fulfilling that which you had promised to deliver in terms of the contract.

Section 24C states that you can claim an allowance if you had entered into a contract and are required to perform under that contract you can claim a section 24C allowance for the future expenditure that you are still going to incur in performing or delivering the promises in terms of that contract.

Performance for tax purposes

From legal point of view, performance by a debtor is that to which he (the debtor) binds himself. Performance can consist of positive conduct (where the debtor must do, deliver or pay something), or negative conduct or an omission.

Performance is therefore similar to accounting performance; it is the promise that he binds himself to delivering.

[41] at paragraph 39
[42] at paragraph 40

Commercial Law[43] puts two provisos in terms of performing under a contract.

Physical Possibility of performance

The performance to which parties have agreed must be capable of delivery. If the object of a performance does not exist at the time of conclusion of the contract, no contract comes into existence.

There are three distinct forms of impossibility of performance.[44]

- impossibility of performance at the time of entering into the contract, which has the effect that no contract comes into existence.
- in some cases it happen that performance is possible at the time of contracting but it becomes impossible afterwards. In such cases a contract does come into being but it is terminated due to impossibility of performance.
- thirdly it may happen that performance is possible but is made impossible by the debtor after the conclusion of the contract. The contract remains in force in such cases and the debtor would be in breach of the contract.

Before impossibility can have an effect of there being no contract coming into being, it must be clear that performance is objectively (absolutely) impossible. It must be impossible for anyone according to the general human experience.

[43] Nagel, C.J., Boraine, A., Lötz, D.J., Otto, J.M., Prozesky, B., Roestoff, M., Theron. L., van Jaarsveld, S.R., (1995). *Commercial Law*. Johannesburg: Lex Patria
[44] at paragraph 6.38

Performance must be determined or determinable

If a party's performance cannot be determined, no obligation comes into being.

There are two well-known examples of determinable performances, these are, generic and alternative obligations.

Generic obligations

If A agrees with B to buy a cow from B's Jersey stud at a particular price, the performance is determinable and the contract valid. Unless otherwise agreed, the election lies with the debtor (B) to select a cow of average quality. This is known as a generic obligation.[45]

Alternative obligation

There is also an alternative obligation where performance is selected from alternatives. In this case the party is given a choice (if not agreed otherwise the choice lies with the party who must perform) to choose the object of performance from various alternatives within a given period or a reasonable period. If A has two houses, and wants to let one to B. The parties agree that A may elect which of the houses he will let to B. As soon as A makes his choice the performance is determined. Before that had happed, performance was determinable and the contract valid.[46]

The fundamentals of both accounting performance and legal performance under a contract are the same. In both instances, there's a party that needs to deliver a promise by the debtor, the other party is also required to honour this and perform their end of the contract and make payment. The timing of the receipt of such payment is what triggers section 24C. If the payment is received in advance and the debtor will be required to deliver his promise (goods or services) at a future date then the debtor can claim a section 24C allowance against the revenue received in advanced for future expenditure that the he will incur in terms of him fulfilling his end of the contract.

[45] at paragraph 6.43
[46] at paragraph 6.44

2.6 - Reversal of section 24C allowance

The last part of this chapter will look at the section 24C(3). This part of the section states;

> The amount of any allowance deducted under subsection (2) in any year of assessment shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment.[47]

This is quite an important part of the section. Taxpayers are likely to claim a section 24C allowance but forget to add back the allowance in the subsequent year.

The purpose of section 24C is to grant taxpayers relief where they have received income in advance and will be incurring future expenditure. The allowance is used to match the genuine revenue portion received against the expenses even though they have not yet been incurred.

A contractor who has calculated that it will take him 12 months to construct a R2,000,000 building at a cost of R1,600,000. His profit for the project will be R400,000. If we assume a tax rate of 28% his total tax for the project would be R112,000 (R400,000*28%).

If the 12 months are spread as follows; 2 months in the current tax period and 10 months in the second tax period. If he receives a payment of R1,000,000 in the second month of the project which falls in the first tax period before he has incurred any costs. In the absence of a section 24C allowance he would be taxed the full R1,000,000 in the first year. His tax liability for year 1 would be R280,000. This would be totally incorrect as he would make no profit at all from the project since he would have used his profits to pay tax.

If he applies a section 24C allowance his allowance against the future expenditure would be R800,000, meaning he would only be liable for tax on only R200,000 of the R1,000,000. His tax would therefore only be R56,000 versus R280,000 had he not claimed the allowance, refer to figure 3 below for detailed calculation.

The principle here is that he was only taxed on R200,000 and not the full R1,000,000 since he was allowed a section 24C allowance of R800,000.

The big question is, when does the R800,000 get taxed since he it wasn't taxed in the first year? This is the reason for section 24C(3), the amount deducted in any year of assessment shall be deemed to be income in the subsequent year of assessment.

[47] Section 24C(3) of the Income Tax Act

Section 24C provided the taxpayer relief in the first year but the taxpayer needs to include year 1's allowance amount when determining year 2's taxable income.

From the below example it is clear that the mechanics of section 24C have worked, the taxpayers profits and taxes are now evenly spread over the 2 years.

Total contract price		2,000,000.00				
Total contract costs		1,600,000.00				
				R		R
				Year 1		**Year 2**
		Gross income		1,000,000.00		1,000,000.00
		Less - Projects costs		-		1,600,000.00
				1,000,000.00		- 600,000.00
		Section 24C allowance - C/Y	Section 24C(2)	- 800,000.00	*	-
		Reversal Section 24C allowance - P/Y	Section 24C(3)	-		800,000.00
		Taxable profit		200,000.00		200,000.00
		Tax @ 28%		**56,000.00**		**56,000.00**
*Section 24C allowance = [(Total costs / Total revenue) × Income received or accrued to date] – Actual expenses incurred to date relating to that income						
Therefore; = [(1,600,000 / 2,000,000) x 1,000,000] - 0						
=	800,000					

Figure: 3

The future expenditure principle, based on what we know about construction contracts, future expenditure is the constructor's cost of making the income that he has received in advance. This will also include asset expenditure (Section 24C(1)(*b*)) in cases where he was required to acquire assets in the performance of his obligation.

Chapter 3 – Requirements for a valid section 24C deduction

In the previous chapter we looked at the provisions of section 24C and went to some detail in explaining some of the key concepts of section 24C.

For a section 24C deduction to be valid there are certain requirements that need to be met.

3.1 - Revenue

The recognition of revenue for both tax and accounting has been dealt with in the previous chapters. Section 24C requires that income has to be included in gross income first before a section 24C allowance can be deducted. This makes absolute sense as an allowance cannot be claimed when revenue received in advance has not been included in gross income. This would defeat the purpose of section 24C. Section 24C is intended to grant taxpayers an allowance against revenue received in advance where they have not yet performed in terms of the contract.

It has also been established that IFRS 15 uses the five step model to recognise revenue received in advance.

- Identify the contract(s) with a customer
- Identity the performance obligations in the contract
- Determine the transaction price
- Allocate the transaction price to the performance obligations in the contract
- Recognise the revenue when (or as) the entity satisfies a performance obligation.

In terms of this model, revenue received in advance is not initially recognised in the profit and loss statement but is rather recognised in the statement of financial position. The revenue received is only moved into the profit and loss statement as and when ownership passes to the customer.

When taxpayers prepare a tax computation for purposes of filing a corporate income tax return the starting point of this tax computation is usually the profit before tax amount.

The profit before tax amount is taken from the profit and loss statement. In instances where IFRS is used to prepare the financial statements we know based on what was discussed thus far in chapter 1 that IFRS 15 does not recognise revenue received in advance in the statement of financial performance. So if this is the case, the profit before tax taken from the statement of financial performance excludes the revenue received in advance amount, since this amount is still in the

statement of financial position. This means the revenue received in advance has not yet been included into gross income and until this has happened, a section 24C allowance cannot be claimed.

This is quite important step that should not be taken lightly as taxpayers often forget that the revenue received in advanced for income tax purposes constitutes income and should be included in the tax computation. If we consider the financial statements of Murray and Roberts, please see below extracts of the statement of financial performance as well as an extract of the statement of financial position. The statement of financial performance *(figure 4*) shows a loss before tax for the period ended 30 June 2020 of R238 million. The statement of financial position *(figure 5*) shows an amount R3,543.2 billion as an amount due to contract customers for the same period. For the purpose of this exercise we will assume that the full R3,543.2 billion was received in advance and similarly the R2,819.9 comparative amount was also revenue received in advance for the 2019 year.

We will recreate the tax computation for this entity as at 30 June 2020. The focus of the recreation will be strictly based on the section 24C impact and no other tax implications will be considered.

Consolidated statement of financial performance

FOR THE YEAR ENDED 30 JUNE 2020

ALL AMOUNTS ARE EXPRESSED IN MILLIONS OF RANDS	Notes	2020	2019*
Continuing operations			
Revenue	25	**20 837,7**	20 112,6
Profit before interest, depreciation and amortisation		**833,7**	1 323,9
Depreciation		**(759,0)**	(418,4)
Amortisation of intangible assets		**(91,6)**	(58,8)
(Loss)/profit before interest and taxation	26	**(16,9)**	846,7
Interest expense	27	**(301,4)**	(125,5)
Interest income	28	**80,3**	69,9
(Loss)/profit before taxation		**(238,0)**	791,1
Taxation expense	29	**(150,5)**	(296,9)
(Loss)/profit after taxation		**(388,5)**	494,2
Income/(loss) from equity accounted investments		**1,9**	(4,2)
(Loss)/profit for the year from continuing operations		**(386,6)**	490,0
Income/(loss) from discontinued operations	30	**15,6**	(143,9)
(Loss)/profit for the year		**(371,0)**	346,1

Figure: 4[48]

Total non-current liabilities		**1 514,9**	1 423,3
Current liabilities			
Amounts due to contract customers	8	**3 543,2**	2 819,9
Trade and other payables	22	**4 273,9**	4 409,4
Short term loans	23	**1 213,1**	521,4
Taxation liabilities	33	**191,0**	134,9
Provisions for obligations	24	**238,8**	220,9
Subcontractor liabilities	21	**1 193,1**	1 074,5
Bank overdrafts	10	**1 111,3**	35,5
Derivative financial instruments		**0,9**	–
Total current liabilities		**11 765,3**	9 216,5
Total liabilities		**13 280,2**	10 639,8
Total equity and liabilities		**18 898,9**	16 390,5

Figure: 5[49]

Example of tax computation

MURRAY AND ROBERTS TAX COMPUTATION – 30 JUNE 2020	
LOSS BEFORE TAX	**(238.0)**
TOTAL DEDUCTIONS	**(2,834.6)**
A - Non-taxable amounts credited to the income statement	**-**
- Reversal of Prior year income received in advance	-
B - Special allowances not claimed in the income statement	**(2,834.6)**
- Section 24C allowance	(2,834.6)
TOTAL ADD BACKS	**3,543.2**
C - Allowances granted in prior years and now reversed	**-**
- Reversal of prior year section 24C allowance	-
D - Amounts not credited to the income statement	**3,543.2**
- Income Received in Advance	3,543.2
ADJUSTED TAXABLE INCOME/(LOSS)	**470.6**

Figure: 6

[48] http://www.murrob.com/pdf/investors/annual-integrated-reports/2020/7_Full_Annual_Financial_Statements.pdf, at page 15
[49] at page 14

From the example above, the tax computation starts with a loss before tax of R238 million as per the statement of financial performance. This is where most tax practitioners would start when constructing a tax computation. The revenue received in advance was allocated to the statement of financial position under current liabilities as 'amounts due to contract customers'. Up to this point the revenue has not yet been brought into gross income as it is still in the statement of financial position and does not form part of the loss before tax.

For a valid section 24C deduction, revenue needs to be included in gross income. The tax practitioner at this point needs to go through the statement of financial position and identify revenue items that have not been brought into revenue, this step is often missed.

In the above example, the amount identified in the statement of financial position as revenue received in advance is R3,543.2 for the 2020 period.

The amount of revenue received in advance should then be brought into the tax computation, (included in gross income). In the example above the amount is brought in under part D; amounts not credited to the income statement.

In the previous chapter, we went through case law and established that revenue received in advance should be included in gross income as it is income. Section 24C will then grant relief to the taxpayer by allowing a deduction against this income.

If we assume that 80% of the revenue will be used to finance future costs and that the R3,543.2 is the total contract price and that there were no current expenses to date incurred against this revenue then the allowable section 24C allowance would be calculated as follows:

Total contract revenue = R3,543.2

Total costs = R2,834.6 (R3,543.2 x 80%)

Section 24C allowance = [(Total costs / Total revenue) × Income received or accrued to date] – Actual expenses incurred to date relating to that income

= [(2,834.6/3,543.2) x 3,543.2] – 0

= R2,834.6

The section 24C allowance of R2,834.6 can now be claimed under Part B in the tax computation (special allowances not claimed in the income statement).

This puts the taxable income at R470.6 million. In the absence of section 24C the full revenue received advance amount of R3,543.2 billion would've had to have been added back and taxed in full. Section 24C in this instance would've provided relief of R2,834.6 billion.

3.2 - Future expenditure

In terms of Interpretation Note: No. 78, future expenditure is expenditure which the Commissioner is satisfied will be incurred by the taxpayer in a subsequent year of assessment (in performing the taxpayer's obligations under the contract) in such a manner that the expenditure –

- will be allowed as a deduction in a subsequent year of assessment; or
- will, in the case of the acquisition of an asset, qualify for any deduction under the Act.

In the previous chapter, it was concluded that future expenditure can be operational or capital in nature as long as it qualifies as expenditure in terms of both section 11(*a*) as well as section 23(*g*) for operational expenditure. If the expenditure is capital, it should qualify for any deduction under the Act.

What is important to remember is that losses or future losses are not expenditure and therefore taxpayers cannot a claim a section 24C deduction for future losses.

Interpretation Note: No. 78 quotes a case *Joffe & Co (Pty) Ltd V CIR*[50] where judge Watermeyer explained the distinction between the two as follows;

> In relation to trading operations the word [loss] is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money.

[50] *Joffe & Co (Pty) Ltd v CIR* 1946 AD 157, 13 SATC 354 at 360.

Interpretation Note: No. 78 also refers to the *Ackermans Ltd v C: SARS*[51] matter where the meaning of 'expenditure incurred' was considered. This meaning is quite important especially in the context of section 23(*g)* as well.

'The meaning of "expenditure incurred" was to be considered in the context of contingent liabilities which had reduced the net purchase price. The taxpayer sold its retail business which included the business assets, the liabilities and the contracts as a going concern. The purchase price was defined as the amount equal to R800 million plus the rand amount of the liabilities. The purchase price was to be discharged by the purchaser assuming agreed liabilities (including contingent liabilities) and the creation of a loan account. The taxpayer claimed a section 11(a) deduction equal to the amount of the contingent liabilities on the basis that by foregoing a portion of the purchase price it had incurred expenditure equal to the amount of the contingent liabilities. Cloete JA disagreed, stating the following:[52]

> To my mind, 'expenditure incurred' means the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability. No liability was incurred by Ackermans to Pepkor in terms of the sale agreement. The manner in which the purchase price was discharged by Pepkor did not result in the discharge of any obligation owed by Ackermans to Pepkor. Ackermans owed Pepkor nothing in terms of the sale agreement and one looks in vain for a clause in that agreement that has this effect. ….
>
> It is clear that what occurred, as is usually the case in transactions of this nature, is that the nett asset value of the business - the assets less the liabilities - was calculated and that this valuation dictated the purchase price. In the ordinary course of purchasing the business as a going concern on this basis it would follow that the liabilities would be discharged by the purchaser. The journal entries relied on by the appellants do not equate to expenditure actually incurred. On the contrary, the mechanism employed in the agreement of sale resulting in the journal entries was to facilitate the sale.
>
> The fact that Ackermans rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, does not mean in fact or in law that it incurred expenditure to the extent that the purchase price was reduced by the liabilities. At the effective date no expenditure was actually incurred by Ackermans.

[51] *Ackermans Ltd v C: SARS* 2010 (1) SA 1 (SCA), 73 SATC 1
[52] At 5 and 6

Interpretation Note: No. 78 states that taxpayers will need to demonstrate that an amount will be outlaid or expended in the future, or that an unconditional legal liability to outlay or expend an amount will be incurred, before the Commissioner will be satisfied that expenditure will be incurred in a subsequent year of assessment.

This falls in the realm of section 23(*g*). Section 23(*g*)[53] states,

> No deductions shall in any case be made in respect of the following matters, namely – ….
>
> (g) any money, claimed as deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for purposes of trade;..

This principle is often missed by taxpayers, if you have not laid out or expended upon any moneys, you will not be successful in claiming a deduction under section 11(*a)* which means your section 24C deduction could be denied.

3.3 - Performance under a contract

Section 24C(2) states:

> If the income of any taxpayer in any year of assessment includes or consists of an amount received under a contract and 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 the taxpayer's obligations under such contract, there shall be deducted in the determination of the taxpayer's taxable income for such year such allowance (not exceeding the said amount) in respect of so much of such future expenditure as relates to the said amount.[54]

The requirements under section 24C(2) are:

- the income received must be received under a contract, and
- the future expenditure must be incurred in the performance of the taxpayer's obligations under a contract.

It is crucial for taxpayers to ensure that a contract exists and that the revenue received in advance has been received under such contract and the future expenditure to be incurred will also be incurred in the fulfilment of the obligations under such contract.

This simply means if there is no contract there will be no section 24C deduction.

[53] Section 23(g) of the Income Tax Act
[54] Section 24C(2) of the Income Tax Act

What becomes problematic though is that in terms of the law of contract tacit contracts are valid however, the onus of proof remains with the taxpayer to proof to SARS that a valid contract exists.

In the absence of a written contract, how would a taxpayer prove to SARS that indeed a valid contract exists?

In the event of an audit, as part of the request for relevant material by SARS, contracts are usually the main support that SARS would be looking for. It is therefore quite important to reduce contracts to writing as part of a taxpayer's defence file.

Interpretation Note. No 78 defines a contract as follows:[55]

> [a]n agreement entered into with the intention of creating an obligation or obligations.
>
> In order for a contract to be valid –
>
> the parties must have the necessary contractual capacity; the performance undertaken under the contract must be possible at the time of contracting; the contract itself, its performance and object must be lawful; and the constitutive formalities (if any) for the contract must have been complied with.

Interpretation Note: No. 78 provides further guidance on the validity of contracts.

> The validity of a contract does not generally depend on compliance with any particular formalities. However, if the parties have agreed on particular constitutive formalities (for example, that the agreement must be reduced to writing and signed by the contracting parties) or if the law requires such formalities (for example, some contracts may need to be in writing or require notarial execution or registration) then those formalities must be met.
>
> Oral contracts are valid when a written contract is not required under a particular law or by the parties to the contract. However, it may be difficult to prove the existence and terms of an oral contract because of the lack of evidentiary proof. A taxpayer wishing to invoke section 24C must be able to prove the existence of a contract, the income received or accrued under that contract, the associated performance obligations and the expenditure related to performing those obligations, to the satisfaction of the Commissioner. SARS recognises that not all contracts are reduced to writing, for example, certain implicit unilateral contracts that are evidenced by a ticket, stamp or voucher. Nevertheless, when possible, it is recommended that taxpayers reduce contracts to writing, for example, in a negotiated contract between two parties.[56]

Taxpayers therefore need to take care when drafting contracts, section 24C requires that the revenue received in advance and the future expenditure must be received and incurred under the same contract. The receipt of revenue and the required performance by the taxpayer cannot be under different contract.

[55] SARS Interpretation Note: No. 78 – 29 July 2014, Allowance for Future Expenditure on Contracts, at paragraph 4.1.1

[56] at paragraph 4.1.1

Interpretation Note: No. 78 provides further guidance and refers to case law.[57]

> In *ITC 1667*[58] the taxpayer entered into rental and maintenance agreements under which the customer agreed to rent copy machines for an agreed monthly rental and the taxpayer agreed to maintain the copy machines. Subsequently, the taxpayer entered into a discounting agreement under which it ceded its rights to the future rental income in return for an up-front lump sum. The court held that the rental and maintenance agreements were legally independent and separate from the discounting agreement. The taxpayer was therefore not entitled to a section 24C allowance as performance of the taxpayer's obligations - the maintaining the copy machines - was not under the same contract under which the lump sum income was received.
>
> In *ITC 1697*[59] the taxpayer, a share block company, received up-front levy income from the share block holders under a usage agreement and in return was required to fulfil certain obligations. These obligations included attending to the repair, upkeep, control, management and administration of the company, the property and the immoveable property and attending to the payment of any related obligation such as salaries, rates and local authority charges like water and electricity. The court confirmed that the relevant agreement for section 24C was the usage agreement under which the income was received and the obligations were incurred, it was not the contracts that the taxpayer had or would conclude with the suppliers of goods and services in order to perform under the usage agreement.
>
> In *ITC 1527*[60] the taxpayer sold furniture on instalment sale and subsequently incurred expenditure in complying with the requirements of the Limitation and Disclosure of Finance Charges Act and the Usury Act. The court held that the future expenditure to be incurred in complying with those Acts was not incurred under the instalment sale contract and did not therefore qualify for a section 24C allowance.

3.4 - Reversal of section 24C allowance

The provisions of Section 24C(3) were looked into in the previous chapter. Taxpayers often worry about getting a section 24C allowance but forget that once you have received or claimed a section 24C allowance in one year, the allowance needs to be included in gross income in the subsequent year. It must be added back to be taxed.

Section 24C(3) states that 'the amount of any allowance deducted under subsection (2) in any year of assessment shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment.'[61]

[57] SARS Interpretation Note: No. 78 – 29 July 2014, Allowance for Future Expenditure on Contracts, at paragraph 4.2.1(c)
[58] *ITC 1667* (1999) 61 SATC 439 (C).
[59] *ITC 1697* (1999) 63 SATC 146 (N)
[60] *ITC 1527* (1991) 54 SATC 227 (T)
[61] Section 24C(3) of the Income Tax Act

How does this reversal work in practice?

If we look into the Murray and Roberts's example, the revenue received in advance in the 2019 year was R2,819.9 billion, this is the 2019 amount for 'amount due to contract customers' disclosed under current liabilities in the extract of statement of financial position. If we assume that this amount was treated exactly the same way in 2019 as how we've the R3,543.2 billion during 2020.

We can therefore conclude the following:

The section 24C allowance granted in 2019 was R2,255.9 *(amounts in billion)*

Total contract revenue = R2,819.9

Total costs = R2,255.9 (R2,819.9 x 80%)

Section 24C allowance = [(Total costs / Total revenue) × Income received or accrued to date] – Actual expenses incurred to date relating to that income

= [(2,255.9/2,819.9) x 2,819.9] – 0

= R2,255.9

The reversal of the prior year allowance in terms of section 24C(3) of the Income Tax Act would be as follows;

The amount deducted in the previous year of R2,255.9 would be added back under part C, allowances granted in prior years and now reversed.

This step is essentially bringing this amount back to be taxed as it was not taxed in the previous year.

Another important step that taxpayers must remember is that the revenue received in advance is manually brought in into the tax computation (to be included in gross income), however the IFRS process will also happen automatically in the subsequent year where the revenue is recognised in the statement of financial performance.

This means in year 2 the revenue that was manually brought into year 1's tax computation will now be recognised in the statement of financial performance and will now be included in profit/loss before tax. It should also now be manually reversed out of the tax computation since it was brought

in and taxed in the previous year (notwithstanding the section 24C allowance claimed against it in the prior year).

Using the example below, the R2,819.9 would've have been brought into the tax computation in 2019 under part D to be taxed as it was revenue received. A section 24C allowance of R2,255.9 would've been claimed against this revenue in 2019 under Part B. The allowance portion was not taxed in 2019 it is therefore manually brought into the 2020 tax computation under part C as a reversal of the prior year section 24C allowance to be taxed.

Due to IFRS 15's revenue recognition methodology, included now in the 2020 loss before tax of R238 is the R2,819.9 as it no longer sits in the statement of financial position but is now recognised to revenue as per IFRS 15 during 2020. Since this amount was brought manually into the tax computation during 2019 and was taxed it will be taxed for second time if it is not reversed out that is why we manually reverse it out under Part A 'Non-taxable amounts credited to the income statement' as it was taxed in the prior year, (20% in 2019 and the 80% is taxed in the current year through the reversal of the section 24C allowance i.e. section 24C(3).

MURRAY AND ROBERTS TAX COMPUTATION – 30 JUNE 2020	
LOSS BEFORE TAX	**(238.0)**
TOTAL DEDUCTIONS	**(5,654.5)**
A - Non-taxable amounts credited to the income statement	**(2,819.9)**
- Reversal of Prior year income received in advance	(2,819.9)
B - Special allowances not claimed in the income statement	**(2,834.6)**
- Section 24C allowance	(2,834.6)
TOTAL ADD BACKS	**5,799.1**
C - Allowances granted in prior years and now reversed	**2,255.9**
- Reversal of prior year section 24C allowance	2,255.9
D - Amounts not credited to the income statement	**3,543.2**
- Income Received in Advance	3,543.2
ADJUSTED TAXABLE INCOME/(LOSS)	**(93.4)**

Figure: 7

3.5 - Deposits

The second part of this chapter will look into deposits. Deposits received can be confusing for taxpayers, as it is often hard to tell if a deposit constitutes revenue or not and if it does, can a section 24C allowance be claimed against it should it be refundable. If it is to be used to purchase materials as is often the case with construction contracts, would it qualify for section 24C allowance, would these section 24C allowances be valid.

SARS has published a draft interpretation note, SARS Draft Interpretation Note: Taxation of the Receipts of Deposits - 23 July 2020 in order to assist taxpayers with the correct treatment. This is still in draft but it does give a window into how SARS views deposits.

Section 1 of the Income Tax Act defines gross income as follows; 'gross income, in relation to any year of assessment, means – (i) in the case any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident;...'[62]

In the context of deposits, the term received by is quite important since a deposit received is likely to constitute a receipt of funds.

The draft interpretation note refers to case law in explaining the term 'received by'.[63]

In *Geldenhuys v CIR* Steyn J stated that "received by" means –[64]

> "received by the taxpayer on his own behalf for his own benefit".

Steyn J went on to state that –[65]

> [t]hough the usufructuary received the purchase price of the sheep she did not become entitled to the money, which remained the property of the remainderman. In my opinion, it never became part of her 'gross income

Schreiner JA stated the following in *CIR v Genn & Co (Pty) Ltd*:[66]

> It is difficult to see how money obtained on a loan can, even for the purposes of the wide definition of 'gross income', be part of the income of the borrower, any more than the value of the tractor which a farmer borrows is to be regarded as being income received otherwise than in cash. … Neither in the case of the borrowed tractor nor in the case of the borrowed or 'hired' money does it seem to accord with the ordinary usage to treat what is borrowed or hired as a receipt within the

[62] Section 1 of the Income Tax Act
[63] SARS Draft Interpretation Note: Taxation of the Receipts of Deposits - 23 July 2020, at paragraph 4.1
[64] *Geldenhuys v CIR* 1947 (3) SA 256 (C), 14 SATC 419 at 430.
[65] at 434.
[66] *CIR v Genn & Co (Pty) Ltd* 1955 (3) SA 293 (A), 20 SATC 113 at 122 and 123.

> meaning of the definition of 'gross income'… It certainly is not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance, money is obtained and banked by someone as agent or trustee for another, the former has not received it as his income. At the same moment that the borrower is given possession he falls under an obligation to repay. What is borrowed does not become his, except in the sense, irrelevant for present purposes, that if what is borrowed is consumable there is in law a change of ownership in the actual things borrowed.

In the draft interpretation note these cases are used to highlight that amounts received by a taxpayer on the taxpayer's own behalf for the taxpayer's own benefit are 'received by' the taxpayer for purposes of gross income and that an amount received on behalf of a third party must not be included in the taxpayer's gross income, since it is received on behalf of another party.

We will only focus on the more common types of deposits and examine the principles in each.

3.6 - Returnable containers

Returnable containers are containers that manufacturers have deemed to be returnable based on some form of criteria. Soft drink and beer manufacturers would often decide based on the strength and quality of specific bottles if they would qualify to be reused in their manufacturing process, not all bottles are the same as some are stronger and can handle being used more than once.

Manufacturers would charge a deposit amount to their customers, the deposit values are generally less than the value of the bottle. The bottles therefore remain the property of the manufacturer as they have not been sold but lent out to the customers. Upon safe return of the container by the customers, the deposit amount is then paid back to the customer.

The standard clause when goods are sold in returnable packaging usually reads as follows:

'Returnable containers, Except as provided below, returnable containers, if any, shall remain the property of Seller. Buyer shall pay a deposit fee, per container, to be determined from time to time by Seller. Upon Buyer returning such container, freight prepaid by Seller, within ninety (90) days from the date of invoice, in good and fully reusable condition…'[67]

[67] Returnable containers Sample clauses, Available at: https://www.lawinsider.com/clause/returnable-containers [Accessed on 23 June 2021]

The question that arises is, are these deposits gross income?

The draft interpretation quotes and makes reference to a few cases;[68]

> In *Pyott Ltd v CIR*[69] the taxpayer charged a separate amount for tins containing biscuits sold to customers. The customers had the option of returning the tins which would entitle them to a refund of the sum charged for tins by the taxpayer if they were returned in good condition. In an obiter dictum the court agreed with the admission that deposits were not trust moneys and commented that if they were, they would not be part of the taxpayer's income. The taxpayer was unsuccessful in trying to argue that the amount should not be included in gross income because it should either be valued at less than the amount of cash received or that a deduction should be allowed for the contingent obligation to pay the customer if the container was returned.
>
> In *Brookes Lemos Ltd v CIR*[70] the taxpayer manufactured and sold fruit squashes and other foodstuffs in glass containers and charged deposits for the glass containers which were refundable upon return of the containers by the customers. There was no obligation on a customer to return the container. The money received was used by the taxpayer in its business and was not deposited into a trust account. It was held that the deposits became the absolute property of the taxpayer and the fact that the taxpayer undertook to refund the deposit if and when the customer returned the container did not change this fact or make the taxpayer a trustee with regard to the deposit. The amounts were held to have been received for purposes of gross income.
>
> In response to the taxpayer's contention that the deposits were security or amounts held in trust and therefore had not been received for purposes of gross income, Watermeyer CJ commented as follows:[71]
>
> "If such amount is really received as trust moneys, of which the recipient is not the beneficial owner but merely a trustee, then doubtless Mr Duncan's contention is correct, but that position does not exist here. The appellant was not a trustee holding the deposits on account of the customers as security for the return of the bottles. Even if the relationship between customer and company could, in common parlance, be loosely so described, it was not such in law. There was no obligation to return the container resting on the customer and the deposit was not a security in the nature of a pledge given to secure performance of such an obligation. Consequently the seller was in no sense a trustee or pledgee. On the contrary the deposits became the absolute property of the Company and they could use them as they pleased; and the fact that they had undertaken an obligation to pay to such of their customers as returned containers an amount equivalent to the amount which they had paid as deposits on similar containers did not constitute the company a trustee with regard to those deposits.

[68] SARS Draft Interpretation Note: Taxation of the Receipts of Deposits - 23 July 2020, at paragraph 4.3.1
[69] *Pyott Ltd v Commissioner for Inland Revenue* 1945 AD 128, 13 SATC, 121
[70] *Brookes Lemos Ltd v CIR* 1947 (2) SA 976 (A), 14 SATC 295
[71] At SATC 299.

In *Greases (SA) Ltd v CIR*[72] the principles of the above cases were confirmed.

> In this case, the taxpayer, a company, supplied grease in drums and charged deposits for the drums which were refundable should the customer return the drums. The drums remained the property of the taxpayer but the court also found that factually there was no obligation to return the drums to the taxpayer. The deposits, which were booked to a suspense account in the accounting records, were used by the taxpayer in its business and not placed in a separate trust bank account. The court held that these amounts were received for purposes of gross income, since the amounts were received by the taxpayer for its own benefit, the taxpayer was entitled to use the amounts in its business and the amounts were not held in trust for the customer. The court held that the taxpayer's contingent obligation to pay customers that returned a drum an amount equal to the deposit did not mean that the deposits were held as trustee on behalf of the customers.

Even though these cases were judged on their own merit, it would be quite difficult for a taxpayer to prove that returnable containers should not be included in gross income, by all accounts they should be included in gross income and taxed.

The question that follows is whether taxpayers would qualify for a section 24C allowance against this income.

Step 1 – There has to have been income received

The receipt of the deposit on sale of the beverage would constitute income received in advance.

Step 2 – The income would have to be included in gross income

Deposit liabilities are usually allocated to the statement of financial position; these would have to be manually brought into the tax computation similar to the Murray and Roberts example.

Step 3 – There has to be contract and the performance obligations have to be determinable.

The contract of sale when beverages are sold to customers would constitute a valid contract. It would have to be agreed under this contract with the customer that when they return the container their deposit amount would be paid back.

The performance obligations for both parties are clear; the one has to return the container whilst the other is obligated to return the deposit amount to the other.

[72] *Greases (SA) Ltd v CIR* 1951 (3) SA 518 (A), 17 SATC 358.

Step 4 – There must be future expenditure to be incurred under the same contract

When the containers are returned, the taxpayer is required to pay the deposit amount to the customer; this would be their performance in terms of the contract. The payment of these funds would constitute expenditure by the taxpayer. This future expenditure would meet the requirements of both section 11*(a)* and section 23(*g*) since funds would be laid out in settlement of the liability.

Returnable containers would therefore qualify for a section 24C allowance. The best approach for taxpayers that use returnable containers is to include the deposit amounts received and then claim a section 24C allowance against the revenue.

3.7 - Rental deposits

Taxpayers who are property owners usually receive rental deposits at the beginning of the lease, should these be included in gross income?

The Rental Housing Act 50 of 1999 applies to the leasing of dwellings which include, houses, hostel rooms, huts, flats apartments, rooms, outbuildings and similar structures. This Act does not apply to commercial property.

Section 5(3) of the Rental Housing Act deems a lease to include certain terms and, among others, includes the following:

- The landlord may require the tenant to pay a deposit before moving into the property.
- The deposit must be invested by the lessor in an interest-bearing account with a financial institution.
- On expiration of the lease agreement, the lessor may apply the deposit and interest towards the payment of all amounts for which the lessee is liable under the lease agreement, such as reasonable costs of repairing damage caused to the property during the lease period and the cost of replacing lost keys. The balance of the deposit and interest must then be refunded to the lessee by the lessor not later than 14 days of restoration of the property to the lessor.

- Should no amount be due and owing to the lessor on expiration of the lease, the deposit with the accrued interest must be refunded to the lessee within seven days of expiration of the lease.

Since the above terms are deemed to be included in a lease, the parties to the lease agreement are bound by them whether they are explicitly included in the agreement or not.

The draft Interpretation note suggests the same income tax principles would be applicable to other leases as well. It does however mention the necessity to evaluate specific contracts before a conclusion is made.

The draft interpretation note further states:[73]

> While the wording of the specific lease agreement is critical, a lessor generally receives the deposit in the position of a trustee and, since the rental deposit is not the lessor's money, has an immediate obligation on receipt of the rental deposit to refund it to the lessee upon termination of the lease. Typically, the lease agreement provides that if the lessee does not meet all of the lessee's obligations as set out in the agreement, for example, the lessee does not return the premises in the same condition and owes the lessor an amount for repairs, that the amount owing by the lessee may be set off against the rental deposit with the net amount being refunded to the lessee. Since the deposit is not the lessor's money and the lessor is contractually liable to refund the rental deposit at the time it is received, the amount is not received by the lessor "on his own behalf for his own benefit" and thus is not included in the lessor's gross income. If the lessee does not meet the lessee's contractual obligations and owes the lessor an amount under the lease, that amount will often represent gross income for the lessor (reimbursement for expenses incurred by the lessor to repair damage to the premises by the lessee, outstanding rent and so on) and therefore to the extent the deposit is applied towards settling amounts owing by the lessee, it generally equals an amount which must be included in the lessor's gross income, if not already included on accrual.
>
> The income tax treatment of a deposit that falls within the ambit of the Rental Housing Act is not necessarily altered by non-compliance with the deemed terms. For example, if a deposit is not invested with a financial institution in an interest-bearing account that does not automatically render the amount to be taxable provided the income tax requirements as considered above in this section of the Note are complied with.

It can therefore be concluded that rental deposits that fall within the ambit of Rental Housing Act should not be included in gross income.

3.8 - Security deposits

There are taxpayers who let equipment or goods as part of their business and require a deposit to be paid on acceptance of a quote to secure the booking as well as to cover the cost of potential damage to the assets or failure to return the assets.

[73] SARS Draft Interpretation Note: Taxation of the Receipts of Deposits - 23 July 2020, at paragraph 4.3.2

In terms of the Draft Interpretation Note[74] the applicable rules would be similar to those of rental deposits, since these deposits are usually held in trust and refundable by the taxpayer at the end of the contract on return of the equipment or goods but may be set off against any amounts owing by the customer for any damage to the items or failure to return the items timeously. In these circumstances, the money is not the taxpayer's and there is an unconditional obligation on the taxpayer providing the goods or equipment to refund the deposit. Therefore, the deposit is not received by the taxpayer "on his own behalf for his own benefit" and accordingly should not be included in the taxpayer's gross income.

Since these are not included in gross income there's no need to consider section 24C.

3.9 - Accommodation deposits

Accommodation establishments often charge a deposit to secure a booking. The deposit is then deducted from the balance of the accommodation fees payable and, subject to the establishment's cancellation policy, may be refunded in whole or in part upon cancellation of the booking. If these are received on the taxpayers on behalf for his own benefit then they should be included in gross income. Should the taxpayer be required to pay the deposit back if there are cancellations then they may claim the payment of the refunds under section 11(*a*) as a normal expense claim in the year of assessment in which it is refunded.

It is important for taxpayers to determine whether the receipts that they have received should be included in gross income or not. If the receipts are not included in gross income then section 24C should not be considered as there's no relief required.

If the amounts are included in gross income, a proper exercise to establish whether they qualify for relief under section 24C needs to be conducted and most importantly taxpayers need to ensure that the section 24C claim that they intend on claiming is valid, based on their own set of circumstances.

[74] SARS Draft Interpretation Note: Taxation of the Receipts of Deposits - 23 July 2020, at paragraph 4.3.4

Chapter 4: Pitfalls by taxpayers in their application of section 24C

The *Clicks*[75] and *Big G*[76] cases have shone a spotlight on section 24C in the recent months.

The taxpayers in both matters lost and this gives the impression that taxpayers are struggling to interpret the provisions of section 24C. This could have serious tax consequences as some of the amounts that are being disallowed are quite large, not to mention interest and penalties.

For these matters to have progressed to the Supreme Court of Appeal on the *Clicks* matter and the Constitutional Court on the *BIG G* matter; one gets the impression that both taxpayers were convinced they had done the correct thing.

We will examine each of these cases to see where the taxpayers went wrong and hopefully provide some guidance for other taxpayers on what to look out for.

4.1 - *Clicks* Case

The background facts were as follows:

> Clicks Retailers (Pty) Ltd, the respondent, owns and operates the well-known Clicks retail business at stores nationwide. Some years ago it instituted a Loyalty Programme in terms of which it awards points to members on presentation of a Clicks ClubCard when making purchases. The accounting and tax treatment of purchases made using a ClubCard and the benefits accruing to members as a result attracted the attention of the appellant, the Commissioner: South African Revenue Services (the Commissioner or SARS as may be appropriate). After conducting an audit the Commissioner disallowed Clicks' claim to an allowance in terms of s 24C(2) of the Income Tax Act 58 of 1962 (the Act). An appeal to the Tax Court, Cape Town (Nuku J) succeeded. The appeal by the Commissioner is with his leave.[77]
>
> The loyalty programme does not apply automatically to all Clicks customers. A customer has to apply either in writing, online or telephonically in order to become a member of the loyalty programme. Upon acceptance of the customer's application, Clicks issues a ClubCard to a customer. A temporary card is issued to a customer who applies in-store. The terms and conditions of the ClubCard contract regulate the relationship between Clicks and the customer under the loyalty programme. It does not cost anything to join the loyalty programme, nor do any financial benefits accrue to either party as a result. Customers in possession of a ClubCard are under no obligation to shop at Clicks. In order to become entitled to points under the loyalty programme a customer must purchase goods and present his or her ClubCard at the checkout point in respect of that transaction. Every R5.00 spent earns one loyalty point. In order to qualify for vouchers customers must accumulate at least 100 club card points by a qualification date. There are four qualification periods

[75] *Commissioner for the South African Revenue Service v Clicks Retailers (Pty)* Ltd (58/2019) [2019] ZASCA 187 (3 December 2019)
[76] *Big G Restaurants (Pty) Limited v Commissioner for the South African Revenue* Service [2020] ZACC 16
[77] Commissioner for the South African Revenue Service v Clicks Retailers (Pty) Ltd (58/2019) [2019] ZASCA 187 (3 December 2019), at paragraph 1

> during which the minimum points have to be earned (6 October-5 January; 6 January – 5 April; 6 April – 5 July; 6 July – 5 October). These periods are referred to as reward cycles.[78]
>
> At the end of each reward cycle, Clicks issues vouchers to all ClubCard members who have earned 100 or more points during the cycle. Every 100 points earned by a customer will entitle that customer to a voucher to the value of R10.00 that can be used in payment or part payment for his or her future purchase. Vouchers may be redeemed by the customer when he or she makes a subsequent purchase and presents his or her club card and voucher at the checkout point. The voucher cannot be redeemed for cash. In practice the vouchers will in almost all instances be used in part payment of a basket of goods, so that the customer acquires those goods at a discounted price.[79]
>
> During the 2009 financial year, Clicks claimed an allowance of R44 275 965 to be deducted from its gross income based on s 24C of the Income Tax Act. The allowance was calculated on the basis of the cost of sales to Clicks, in honouring vouchers that Clicks expected members to redeem in the following tax year. The Commissioner disallowed the claim to the allowance and Clicks objected to the disallowance. On 29 April 2015 it lodged an appeal against the disallowance of its objection against the assessment for the 2009 tax year.[80]

The appeal was upheld by the Tax Court and the Commissioner was directed to partially allow the section 24C claim. The tax Court gave the following reasons for allowing the claim.

> (a) It was artificial and factually incorrect, to regard the expenditure Clicks would incur when a customer redeemed a voucher, as arising under a 'different contract' to the first purchase and sale contract concluded with the same customer and pursuant to which the points concerned, were generated.
>
> (b)The first purchase and sale agreement incorporated the terms of the ClubCard contract, but despite this the first purchase and sale contract remained the contract that triggered both the earning of income by Clicks as well as an obligation by Clicks to incur future expenditure.
>
> (c) The obligation to incur future expenditure was therefore incurred under the same contract from which the income was earned and the expenditure would be incurred in the performance of that contract. Consequently the claim of Clicks in terms of s 24C, met the requirements of this section.[81]

Judge Dlodlo in delivering the judgment referred to the *Big G* case when that appeal was before the Supreme Court.

The Supreme Court had held that 'in order to qualify for an allowance the income received and the future expense incurred, must arise from the same contract…. The section therefore envisages income, future expenditure and a single contract that links the two…'[82]

[78] at paragraph 2
[79] at paragraph 3
[80] at paragraph 4
[81] at paragraph 5
[82] at paragraph 7

The Commissioner submitted the following as reasons for disallowing the claim;

> (a) The contract of purchase and sale, whereby a customer purchased merchandise at a Clicks store, in terms of which income was received, was separate from the ClubCard contract;
>
> (b) The ClubCard contract itself did not give rise to any income in the hands of Clicks, because it was issued free of charge and there were no hidden charges to members;
>
> (c) The obligation of Clicks to award the member points, based on qualifying sales and to issue vouchers, when the specified number of points had been earned, arose under the ClubCard contract;
>
> (d) Clicks was likely to incur future expenditure, when a member redeemed a voucher and Clicks supplied the member with goods equal to the value of the voucher, at no cost to the member. This obligation would arise under the ClubCard contract, which was a different contract from the contract of purchase and sale, under which the income was received.[83]

The Commissioner contended that there were at least separate contracts;

> (a) The ClubCard contract, from which no income was derived, as it was concluded free of charge and imposed the obligation on Clicks to issue and honour vouchers and thereby incur future expenditure;
>
> (b) The first contract of sale, which earned income for Clicks, but from which no obligation to honour vouchers and thereby incur future expenditure was imposed upon Clicks; and
>
> (c) The second contract of sale, which earned income for Clicks and against which the customer was entitled to redeem his or her voucher. [84]

The Commissioner submitted that Clicks had been unable to prove that the first contract of sale was the same contract that gave imposed the obligation on Clicks to incur future expenditure.

Judge Dlodlo also made the same observation regarding the issue of three separate contracts, he states; 'the contract that creates the right to income by Clicks is the first contract of sale. However, the contract that obliges Clicks to honour the vouchers and thereby incur expenditure, when a customer concludes the second contract of sale with Clicks, is neither that contract, nor the second contract of sale, but the ClubCard contract. Consequently, the expenditure incurred by Clicks in honouring the vouchers does not arise in terms of the same contract i.e. the first contracts of sale, but in terms of the separate and distinct ClubCard contract.'[85]

The fact that there was more than one contract and the fact that the Supreme Court had held that even in instances where the contracts could be seen as inextricably linked, an allowance could only be claimed if there was one contract that linked the income and future expenditure.

[83] at paragraph 9
[84] at paragraph 10
[85] at paragraph 18

The appeal was upheld and the order of the Tax Court was set aside.

Summary

This case can be summarized as follows:

The court did not make a determination on whether Clicks was entitled to a section 24C allowance based on the mechanics of section 24C. The court made its findings based on the contracts that Clicks had entered into with its customers. Clicks' section 24C allowance was disallowed purely on the basis that the contract that created the income was not the same contract that gave rise to the obligation to incur the future expenditure.

It is important to note that the South African Revenue Services also only challenged the contracts and not whether Clicks did in fact qualify for section 24C allowance in the practical sense.

The court did not go through the mechanics of Click's accounting and tax treatment of the transactions. The only reference to this was in paragraph 1 of the judgment where it is said that the tax and accounting treatment was what had attracted the attention of the South African Revenue Services. It would have been quite interesting had the court looked further into the accounting and tax treatment of Click's transactions.

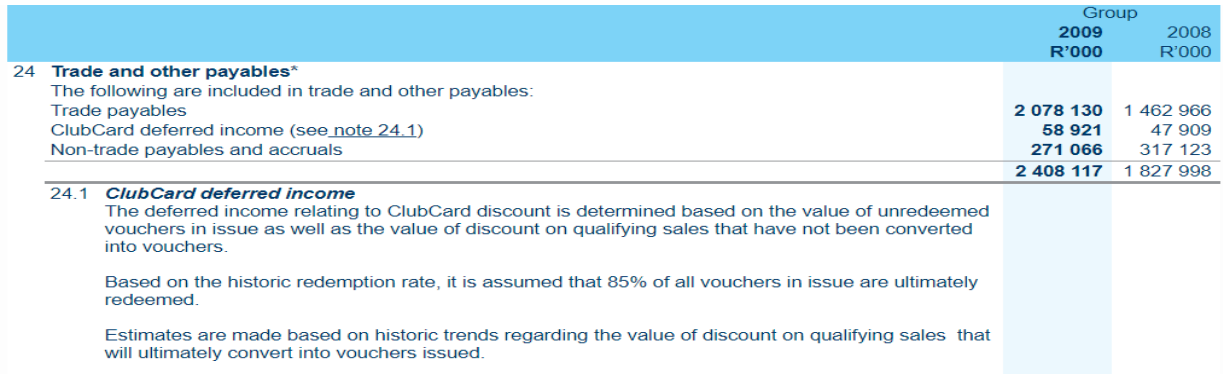
Since the technical parts of the transactions were not looked into in the judgment, below is a summary of what would have happened in Clicks' accounting records as well as on the tax computation and tax return.

In terms of IFRS, from an accounting point of view the Clicks loyalty programme is a discount scheme. As was mentioned in previous chapters when we looked at the provisions of IFRS 15 an entity cannot raise revenue until such time that all the performance requirements have been met by both parties. In this case, revenue can only be raised once the vouchers have been redeemed. IFRS 15 was not yet applicable during the period in question, however Clicks' accounting treatment of the transactions was similar to what IFRS 15 would have prescribed.

What this means is that Clicks, from an accounting point of view cannot realise all the revenue its received from the first contract of sale. It should only realise a portion of the revenue since there's also a revenue received in advance portion that has been created by the loyalty program. The revenue received in advance portion will only be recognised upon redemption of the vouchers.

From a tax point of view however, the revenue received in advance is taxable since the cash was received. The principles in *Geldenhuys*[86] are met by Clicks, the cash is received by the taxpayer on his own behalf for his own benefit.

Clicks' Group Financial Statements[87] for the period in question show an amount of R58,921,000 being Club Card deferred income, refer to figure 8 below. This is the portion that Clicks could not raise as revenue in the income statement from accounting point of view. This amount is disclosed in note 24 under trade payables in the balance sheet.



		Group 2009 R'000	2008 R'000
24	**Trade and other payables***		
	The following are included in trade and other payables:		
	Trade payables	**2 078 130**	1 462 966
	ClubCard deferred income (see note 24.1)	**58 921**	47 909
	Non-trade payables and accruals	**271 066**	317 123
		2 408 117	1 827 998

24.1 ***ClubCard deferred income***

The deferred income relating to ClubCard discount is determined based on the value of unredeemed vouchers in issue as well as the value of discount on qualifying sales that have not been converted into vouchers.

Based on the historic redemption rate, it is assumed that 85% of all vouchers in issue are ultimately redeemed.

Estimates are made based on historic trends regarding the value of discount on qualifying sales that will ultimately convert into vouchers issued.

Figure 8[88]

When we looked at the Murray and Roberts example earlier, specifically figure 6 – the tax computation - we dealt with the mechanics of section 24C. In this case Clicks would have recognised the R58,921,000 (amount could have been different on final submission of tax return) deferred income as an add back under - D Amounts not credited to the income statement - and would then have claimed a section 24C allowance of R44,275,965, a deduction under - B Special allowances not claimed in the income statement. It is important to stress the point that from a tax technical point of view Clicks had done everything by the book and had only failed to prove its case purely on the contracts, the case was decided on the contracts.

[86] *Geldenhuys v CIR* 1947 (3) SA 256 (C), 14 SATC 419

[87] https://www.clicksgroup.co.za/IRDownloads/AnnualReport2009/financial/group_f.asp[Accessed on 19 May 2021]

[88] https://www.clicksgroup.co.za/IRDownloads/AnnualReport2009/financial/notes2.asp#24[Accessed on 19 May 2021]

It is also important to note that the tax court had found in favour of Clicks and allowed the allowance. The South African Revenue Services challenge was not on the accounting and tax treatment but rather on the contracts.

One could draw the conclusion that had Clicks only had one contract there would never have been any grounds to challenge their section 24C allowance.

The principle in this case is that taxpayers have to ensure that there is only one contract giving rise to the income and the same contract creating the obligation for the incurral of future expenditure.

4.2 - The *Big G* Case

What is important with the BIG G matter is that it found itself at the Constitutional Court, the reason for this was because there were two opposing sides putting good arguments for and against the section 24C allowance. The Tax Court had put a well-reasoned argument as to why it should be deductible whilst the Supreme Court had also put compelling reasons why it should be disallowed.

This had led to the matter finding its way to the Constitutional Court; judge Madlanga had argued that it was indeed worthy of being heard in the Constitutional Court on the basis that '… there was an 'arguable point of law of general public importance which ought to be considered by that Court…'[89]

The background facts of this case are as follows:

> The applicant, Big G Restaurants (Pty) Ltd (Big G), is a franchisee operating a number of Spur and Panarottis restaurants in terms of written franchise agreements concluded with a franchisor, the Spur Group (Pty) Ltd (Spur Group). It claimed from the respondent, the Commissioner of the South African Revenue Service (Commissioner), a section 24C(2) allowance for the 2011−2014 years of assessment for the future costs of revamping its restaurant premises. These costs 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): income received from customers in terms of individual contracts of sale between it and its customers was income received in terms of the franchise agreements between it and the Spur Group; and costs of revamping the premises constitute "future expenditure" as envisaged in section 24C of the Income Tax Act. Big G's stance was that the income from customers has to be used in whole or in part to finance the

[89] Section 167(3)(b)(ii) of the Constitution of the Republic of South Africa

> inevitable future revamping expenditure which will be incurred by it in the performance of its obligations under the franchise agreements.[90]
>
> The Commissioner disallowed the allowance and raised an additional assessment for the 2011−2014 years of assessment. The substance of why he did so is this: the income in respect of which an allowance is claimed must have accrued in terms of the same contract that imposes the future expenditure in respect of which the allowance is 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 individual customers at its restaurants; the future expenditure is not imposed by those contracts; and, that the future expenditure is imposed by different contracts, these being the franchise agreements between Big G and the Spur Group.[91]

The approach by the Commissioner is similar to that of the Clicks case where the Commissioner is arguing that the contract that gave rise to the sale is not the same contract under which the taxpayer is obligated to perform and incur future expenditure.

BIG G objected to the additional assessments and appealed to the Tax Court. The parties asked the Tax Court to determine two issues namely;

(a) whether the income received by Big G from operating the franchise businesses includes or consists of any amount received or accrued to Big G in terms of the franchise agreements as envisaged in section 24C of the Income Tax Act; and

(b) whether the expenditure required to refurbish or upgrade is incurred by Big G "in the performance of the taxpayer's obligations under such contract" as envisaged in section 24C.[92]

The Tax Court ruled in favour of *BIG G* and set aside the additional assessments. The reasoning provided as was that the franchise agreements imposed an obligation to BIG G to actively provide and sell meals to customers. Although customers are not parties to those agreements, the proximate cause of those sales is this obligation. In each case this obligation appeared in the same contract that contains the obligation to refurbish the premises. The potential to refurbish is the future expenditure envisaged in section 24C(2).[93]

The Commissioner appealed the Tax Court decision. The Supreme Court of Appeal upheld the appeal and set aside the decision of the Tax Court. The court ruled that the income received by Big G was as a result of contracts with customers and that the income that accrues from those sales is not as a result of the franchise agreements. Therefore, there are two different contracts.

[90] *Big G Restaurants (Pty) Limited v Commissioner for the South African Revenue Service* [2020] ZACC 16, at paragraph 2
[91] at paragraph 3
[92] at paragraph 4
[93] at paragraph 6

In his judgment Judge Madlanga draws a comparison between a franchised restaurant and an unattached restaurant to prove his point.

> The Tax Court relied on a number of terms of the franchise agreement. One is clause T.16. In terms of this clause the franchisor may cancel the franchise agreement if the franchisee fails to actively operate the franchise business. The Tax Court and Big G read this to mean that the franchise agreement itself imposes an obligation on the franchisee to sell food, something which "constitutes [the franchisee's] sole business in terms of that agreement". The Tax Court concludes this point by saying "[t]he income generated from the sale of those meals is of course the same income that accrues to the taxpayer". The Tax Court also placed reliance on clause E.5 of the franchise agreement which requires the franchisee to "continuously exert its best efforts to promote and enhance the business of the restaurant". The Court read this to support the "inference that an obligation is imposed on the taxpayer [by the franchise agreement] to actively provide meals to its customers".[94]
>
> At first blush this is compelling. But it does not bear scrutiny. A useful way of demonstrating this is using, as comparators, restaurateurs who are not operating under a franchise agreement (unattached restaurateurs). If an unattached restaurateur does not sell food, the business will fail. If serious about the business, the unattached restaurateur has an obligation – call it self-imposed – to make sure that the business succeeds. At the centre of that obligation is selling sufficient volumes of food. In substance this obligation is exactly the same as that of a Spur or Panarottis franchisee.[95]
>
> The business of both will fail if they do not sell food. Without question, income derived from the sale of food by the unattached restaurateur does not entitle her or him to the section 24C(2) allowance. If I must explain, that is so for the simple reason that there is no contract in terms of which the unattached restaurateur has to fund future expenditure from income derived from that same contract. Must a franchisee derive the benefit of the allowance purely because there is the interposition of a franchise agreement which tells the franchisee to do something she or he would have had to do anyway? I think not. An unattached restaurateur faces the same fate as the franchisee if she or he does not run her or his restaurant in a business-like manner: the business will fail. The two are similarly placed and have the same obligation.[96]
>
> Big G emphasised that it is in a similar position as building contractors and manufacturers for whose benefit section 24C was originally intended. It then made the point that – if the allowance were to be denied – it would find it difficult to perform its periodic upgrade or refurbishment obligations under the franchise agreement. If her or his restaurant is not to ultimately become a dump that eventually fails, an unattached restaurateur also has obligations that relate to the upkeep of the restaurant. She or he may also face the same difficulty Big G is referring to. The magnitude and frequency of expenditure relating to upkeep will depend on a variety of factors. A few examples of these are the level at which the restaurant is operating, the size of the restaurant and how busy it is. An unattached so-called fine dining restaurant may even have standards that are more exacting and costly than those of a Spur or Panarottis restaurant. Thus in substance, I see no principled basis which sets apart restaurants operated under Spur or Panarottis franchise agreements.[97]

Judge Madlanga argued further that it would be absurd to allow Big G to enjoy the benefit of an allowance under section 24C whilst denying it to unattached restauranteurs who are similarly placed. He stated further that an interpretation that gives rise to that differential treatment of

[94] At paragraph 20
[95] At paragraph 21
[96] At paragraph 22
[97] At paragraph 27

unattached restauranteurs would be unjust. An interpretation that avoids an injustice should be preferred to one that does the opposite.[98]

He summed up his judgment by saying 'I am not satisfied that Big G has been able to place the contracts in terms of which it earns an income from its customers within the ambit of the income earning contract envisaged in section 24C. And, quite clearly, 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 makes section 24C inapplicable.'[99]

The appeal was dismissed with costs.

Summary

The principle of this case yet again rests on contracts. Taxpayers need to make certain that the same contract that gives rise to the revenue is the same contract that creates the obligation to incur the future expenditure.

Both cases are similar in that the Commissioner on both cases had targeted the link between the income-generating contract and the obligation-creating contract. Three different contracts were identified in the *Clicks* case whilst two were identified in the *BIG G* case.

Since BIG G Restaurant (Pty) Ltd is not listed like Clicks, its financial records are not available to the public.

It would have been useful to conduct an analysis on the technical application of section 24C from Big G's point of view similar to what we've done in the Clicks summary above.

If an assumption was made as to what the accounting and tax treatments would have looked like, it might have looked as follows:

BIG G would have reclassified a portion of its revenue to the balance sheet and treated this as income received in advance. In the absence of this entry, I cannot see how they would have got the section 24C claim past their auditors.

[98] At paragraph 28
[99] At paragraph 29

The accounting treatment of income received in advance in most instances lays the foundation for a valid section 24C allowance. This treatment suggests that revenue has been earned which from an accounting point of view is not recognisable as income because the parties have not performed all the requirements in terms of the contract of sale. It would be difficult to justify a section 24C allowance where the revenue was regarded as taxable income for both accounting and tax purposes. In most section 24C instances, the accounting treatment almost always suggests that the taxpayer is not entitled to the revenue they've received and therefore should not recognise it in the income statement. For income tax purposes, the revenue received in advance is taxable since the income has been received for the company's own benefit. This revenue is then included in gross income through an add back in the tax computation. A section 24C allowance would then be claimed against the revenue that has been included into gross income. This would be similar to both our previous examples, Murray and Roberts as well as Clicks. In the absence of this flow, proving a section 24C allowance would be difficult if not impossible.

Assuming the steps mentioned above were followed, the next step would be to prove that a portion earned on the revenue from the sale of food by Big G would be utilised in settlement of future expenditure to be incurred in providing the food that has been consumed – in terms of IFRS, the provision of food and consumption there-of would be one contract. This would be impossible to prove because there is no correlation between the food sold and the future expenditure to provide it since that sale contract has already concluded.

This is where this claim fails, the contract for the sale of food is concluded immediately when the food is consumed and payment received. There is no deferment of revenue nor costs in the contract of the sale of the food, this means this portion of revenue is immediately taxable for both tax and accounting.

The franchise contracts that create an obligation for the franchisee to refurbish the premises are not linked to the contract for the sale of food, this obligation is created by a separate contract.

In my view the court's decision was correct there are indeed two separate contracts. The court's decision is also supported by the accounting treatment. I have illustrated above that all the conditions in terms of IFRS 15 for the contract of the sale of food were concluded when the food was consumed by the customer and the payment received by BIG G. At that point both BIG G and the customer had no further performance requirements in terms of that contract with each other.

The taxpayer in this case had misinterpreted the provisions of section 24C.

It is therefore of utmost importance that taxpayers apply the provisions of a section the way it was intended.

Both the *Big G* and *Clicks* cases were decided on contracts. It has also been noted from the above analysis that contracts also play a major part in accounting especially in determining the accrual of revenue for IFRS purposes.

Another interesting take out from these cases is that both taxpayers are not in the construction sector and notwithstanding the issue of the contracts; both were entitled to claim a section 24C allowance. The taxpayers' entitlement to a section 24C claim were legitimate, what was challenged was whether they had met the requirements for a valid section 24C allowance. Case law also confirms that section 24C is available to all taxpayers as long as they meet the requirements for a valid claim.

Chapter 5 - Conclusion

This research report had set out to assist taxpayers in navigating through section 24C.

It had also sought to illustrate the major pitfalls that taxpayers find themselves in when trying to comply with the provisions of section 24C.

The accounting treatment of revenue received in advance drives the practical application of section 24C. Through the reconstruction of tax computations it was shown that a good understanding of the accounting treatment of revenue received in advance plays a role in adhering and complying with the provisions of section 24C.

The approach that IFRS 15 has adopted in recognising income also reaffirms this relationship between accounting and tax. We've been able to demonstrate that if the principles of IFRS 15 are applied correctly then the application of section 24C becomes quite seamless.

The adoption of IFRS 15 only commenced in 2018 for reporting periods beginning on or after 1 January 2018. As more and more entities settle in applying IFRS 15, there is a sense that the revenue authority will also find comfort in how section 24C is applied. There's a clear correlation between the correct application of IFRS 15 and the correct application of section 24C.

It has been demonstrated throughout the report that navigating through section 24C could be quite challenging.

The worst injustice would be for a taxpayer who genuinely qualifies for a section 24C allowance to miss out simply because they did not understand its provisions or in some cases weren't even aware that it exists.

Based on what has been discussed and examined in the past chapters we can formulate a toolkit for taxpayers to use in deciding whether they qualify for a section 24C allowance or not.

It should be noted that even though section 24C was initially created to provide relief for contractors and certain manufacturers, it can actually be utilised by any taxpayer who meets the requirements.

In *ITC 1697* Galgut J stated ;

> The fact that the allowance might have been intended for building contractors does not mean, however, that it is not available to others. On the contrary, by the particular wording of s 24C the types of trades that the individual taxpayer might carry on, and the types of contracts concerned, are in no way limited. The sole question is whether the provisions of s 24C otherwise apply. . . .[100]

The research report had set out to provide a guide for taxpayers to use in deciding whether they qualify for a section 24C allowance.

Judge Wallis, in his concurring judgment in the *Clicks* case summarized the requirements perfectly.

> The interpretation of s 24C is straightforward. First, it requires the conclusion of a contract under which revenue is received by the taxpayer. Second, it requires the taxpayer to undertake obligations under that contract to be performed in the following tax year. Third, the performance of those obligations must oblige the taxpayer to incur expenditure in the future. Fourth, the revenue received from the contract must be used to finance the performance of the taxpayer's obligations under the contract…[101]

These four points can be summarised as follows;

- *Step 1 – Conclusion of a contract in which revenue is received*
- *Step 2 – Taxpayer obligation under the same contract to be performed in the subsequent year*
- *Step 3 – Performance of the obligations must result in future expenditure*
- *Step 4 – The revenue received from the contract must be used to finance the performance of the taxpayers obligations.*

These simple steps should equip taxpayers when deciding whether the provisions of section 24C apply to them or not.

It is quite clear based on these recent cases that SARS is looking at section 24C, if possible taxpayers should seriously consider making use of legal experts when drafting contracts for section 24C purposes. These are crucial, as they will need to pass scrutiny should they ever be evaluated in by the courts.

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[100] *ITC 1697* (1999) 63 SATC 146 (N) at 155.
[101] *Commissioner for the South African Revenue Service v Clicks Retailers (Pty) Ltd* (58/2019) [2019] ZASCA 187 (3 December 2019), at paragraph 32

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