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Global Tax Alert

South Africa's Constitutional Court addresses tax-deductible allowance for future expenditure on contracts

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Executive summary

South Africa's tax-deductible allowance for future expenditure on contracts (i.e., section 24C of the *Income Tax Act No 58 of 1962* (the Act)) has again come under scrutiny during the delivery of the Constitutional Court Judgment in *Big G Restaurants (Pty) Ltd v CSARS* on 21 July 2020.

The purpose of section 24C is to address the anomaly that arises when income is received under a contract in one year and the expenditure is incurred to perform under that contract in a subsequent year of assessment. The section 24C allowance provides tax relief to the taxpayer where a mismatch between income and expenditure occurs in a tax year by putting the taxpayer in the same position as it would have been had the taxpayer earned the income and incurred the expenditure in the same tax year.

As with the current case, many disputes relating to the section 24C allowance are related to the requirements set out in section 24C(2) noting that:

> "If the income . . . includes or consists of an amount received by or accrued to [the taxpayer] in terms of **any contract** and [the Commissioner is satisfied that][1] 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**" (*own emphasis*)

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This may be a positive development for certain taxpayers as the Constitutional Court (CC) emphasized that the reference to "any contract" and "such contract" results in a requirement of "sameness." The CC however held that the "sameness requirement" does not connote that there must be only one piece of paper stipulating the income earning and the obligation imposing of future expenditure if it is a written contract. It concluded that **there can be two or more contracts that may be inextricably linked which can satisfy this "sameness" requirement**.

This however does not mean that a floodgate is open for taxpayers to claim the section 24C allowance, as Mandlanga J, carefully and specifically linked the relevance of interpreting section 24C(2) to the legal question of interpreting the contracts. It thus still remains a factual enquiry. This is one of the reasons why the Taxpayer, Big G Restaurants (Pty) Ltd, was unsuccessful in claiming the section 24C allowance for tax purposes.

Detailed discussion

Background

Big G (the Taxpayer) has a number of restaurants which it operates as a franchisee in terms of written franchise agreements concluded with the Franchisor Group. Big G claimed a section 24C allowance for the 2011 to 2014 years of assessment for the future costs of refurbishing/upgrading its restaurant premises, as a direct result of a stipulation in the franchise agreements requiring Big G to do so.

The section 24C allowance was claimed on the basis that the revenue received from customers in terms of individual contracts of sale was income received in terms of the franchise agreements (i.e., **income earning requirement**) and the costs of revamping the premises constitute "future expenditure" which will be incurred by it in the performance of its obligations under the franchise agreements (i.e., **obligation imposing expenditure requirement**).

The South African Revenue Service (SARS) disallowed the section 24C allowance and raised additional assessments for the years in dispute on the basis that the income in respect of which the 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. SARS was of the view that Big G's income earning requirement for purposes of the section 24C allowance was earned from income that accrued in terms of contracts concluded by it with individual customers at its restaurants, while the future expenditure is imposed by different contracts, being the franchise agreements.

The Tax Court had set aside the additional assessments, based on the reason that the franchise agreements imposed an obligation on Big G to actively provide and sell meals to customers, with the proximate cause of those sales being an obligation that appeared in the same contract.

The Supreme Court of Appeal set aside the Tax Court decision, on the basis that Big G receives income as a result of the contracts it concludes with individual patrons who come into its restaurants to buy food – thus meaning the income does not accrue in terms of the franchise agreements.

Issues for consideration

The CC had to consider two issues:

1. Does the CC have jurisdiction to hear the matter; and
2. The interpretation of section 24C, and more specifically the interpretation of the words "in terms of" as used section 24C, while having regard to the interpretation of the franchise agreements and the contracts of sale of food to customers.

The Constitutional Court Judgment

1. Does the CC have jurisdiction?

The CC agreed with Big G's argument that the matter raises an arguable point of law of general public importance which ought to be considered.

The CC noted that the interpretative question is a quintessential point of law, which requires certainty and the point bears a reasonable prospect of success. It also noted that it is in the general public interest given that there are several other similar franchisees spread across South Africa and that it is unlikely that the relevant franchise agreements are unique.

The minority judgment provided by Majiedt J, did not support the above findings and noted that the matter lacked Constitutional Court jurisdiction as it is patently obvious that there is no question of law involved in the matter, but purely a factual enquiry on which contract applies to section 24C allowance.

2. *The interpretation of section 24C, and more specifically the interpretation of the words "in terms of" as used section 24C, while having regard to the interpretation of the franchise agreements and the contracts of sale of food to customers*

The CC considered Big G's submission that the contracts of sale of food have to be read as part of the franchise agreement, which then meant that income earned in terms of the sale of food contracts is income earned in terms of the franchise agreement. Stated differently, the CC had to determine if the sale of food contracts satisfied this "sameness" requirement noted above.

The CC stated that a franchisee cannot just derive the benefit of the allowance purely because there is a franchise agreement, which tells the franchisee to do something he/she would have had to do anyway. It was effectively noted that the franchise restaurant must be scrutinized/compared to an independent and unattached restaurant which does not operate under a franchise agreement, as they are similarly placed and have the same obligation. Both face the same fate in that if the restaurants are not run in a business-like manner and sell sufficient volumes of food, both will fail.

The CC understood that a franchisor wants to maintain standards, goodwill and guarantee returns through stipulating the manner in which the franchisor insists the franchise business has to be run. However, the CC also referred back to the circumstances of an unattached restaurateur, which would also have its personalized requirements to operate its restaurant with a view to build/maintain goodwill and guarantee income.

Big G had emphasized that it is in a similar position when compared to a building contractors/manufactures for whom section 24C was originally intended and if such allowance is denied it would find it difficult to perform the periodic upgrade/refurbishment obligations as per the franchise agreement. The CC again compared these obligations to an unattached restaurateur that also has the obligations to upkeep the restaurant. The CC stated that both face the same difficulty to fund such upgrade/upkeep and therefore there is no principled basis to set the two restaurants apart.

The CC for the reasons noted above concluded and Madlanga J held that:

> "It would be absurd in the extreme to allow Big G to enjoy the benefit of an allowance under section 24C whilst denying it to unattached restaurateurs who, as I find, are similarly placed. Likewise, an interpretation that gives rise to that differential treatment of unattached restaurateurs would be unjust. An interpretation that avoids an injustice should be preferred to one that does the opposite."

The CC in summary held that the contracts in terms of which Big G earns income from customers for selling food fall short of the income earning contract as envisaged by section 24C. The obligation that Big G must refurbish/upgrade is in terms of the franchise agreements and not the sale of food contracts. This therefore lacks correlation between income earning contracts and obligation imposing contracts – making section 24C plainly inapplicable.

The CC also held that Big G would still derive a benefit from expending monies towards the upgrade/refurbishment obligation as it would be entitled to a deduction in terms of section 11 of the Act. Big G will simply not be entitled to make an upfront deduction under section 24C of the Act.

Implications

Section 24C of the Act grants a taxpayer with a temporary allowance which has the effect of not having to pay tax on income which will be used to fund future deductible expenditure. The relief is only granted until such time that the expenditure is actually incurred.

The CC's interpretation of section 24C of the Act will be welcomed by many taxpayers, as such interpretation does not deprive taxpayers of an opportunity to benefit from the relief provided in section 24C just because of the manner in which the taxpayer's contracts are formulated.

The CC's "sameness requirement" confirms that the references to "contract" does not limit a taxpayer to only one contract. The notion is therefore confirmed that receipt of the income and the obligation to incur future expenditure in terms of section 24C can be in separate contracts which are inextricably linked. Emphasis should however be placed on that the application of section 24C remains a question of fact.

Endnote

1. In 2015 the law was amended to remove the Commissioner's discretion.

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