IN THE TAX COURT OF SOUTH AFRICA

(HELD AT CAPE TOWN)

CASE NO: 13988

In the matter between:

ABC (PTY) LIMITED **Appellant**

and

THE COMMISSIONER FOR THE

SOUTH AFRICAN REVENUE SERVICE **Respondent**

Date of Hearing : 14 August 2018
Date of Judgment : 1 November 2018

JUDGMENT

NUKU, J

[1] This matter concerns a claim for an allowance in respect of future expenditure on contracts under section 24C of the Income Tax Act 58 of 1962, as amended ("*the ITA*"). The appellant is a wholly-owned subsidiary of New ABC South Africa (Pty) Ltd, and a member of the ABC Group of Companies. It owns and operates the ABC retail business, which is to sell, through ABC stores nationwide, merchandise under the following categories: Health and Pharmacy; Beauty; Fragrance; Toiletries; Baby; Men; Electrical; and Household.

[2] The appellant conducts a loyalty programme in terms of which it awards points to members on presentation of an ABC loyalty card when making purchases. The loyalty programme does not apply automatically to all ABC customers: A customer has to apply either in writing, online or telephonically to become a member of the loyalty programme. Upon acceptance of the customer's application, the appellant issues an ABC loyalty card to

the customer. For ease of reference I refer to the agreement entered into between the Appellant and the customer upon acceptance of the customer's application as "*the loyalty card contract*".

[3] The terms and conditions of the loyalty card contract include, *inter alia*, the following:

> 3.1 A customer earns points when making purchases above R10 at any of the ABC stores. In order to earn such points, a customer must present his or her loyalty card at checkout when making the said purchase. No points are earned by the customer who does not present his or her loyalty card at checkout when making a purchase, despite the fact that the customer is a member of the loyalty programme.
>
> 3.2 A Customer must spend at least R10 in order to earn points and, thereafter, for every R5 spent, one point is earned.
>
> 3.3 Customers qualify for vouchers by earning at least 100 loyalty card points during a qualification period. A qualifying period is a cycle of three months and there are four qualification periods in a year during which the minimum points have to be earned. The appellant advised that for the relevant period these qualifying periods were from 6 October – 5 January; 6 January – 5 April; 6 April – 5 July; and 6 July – 5 October. At the end of each qualifying period, the appellant issues vouchers to all members who have earned 100 points or more during that qualifying period.

[4] Every 100 points earned by a customer will entitle that customer to a voucher to the value of R10 which can be used in payment or part payment of a future purchase at one of the appellant's stores. The value of the reward, in turn, equates to 2% of the customer's actual spend, i.e. one point is earned for every R5 spent and this is subject to a minimum transaction value of R10.

[5] Vouchers may be redeemed by the customer for merchandise in any of the ABC stores, i.e. when the customer makes a subsequent purchase and presents his or her loyalty card and voucher at checkout. The voucher cannot be redeemed for cash. Thus, if a member presents a voucher at checkout, the appellant is obliged to supply the member with selected goods that have a retail value up to the value of the reward.

[6] When a customer presents his or her loyalty card at checkout, the customer's loyalty card membership number and the number of loyalty points he or she has earned as a result of that transaction are reflected on the till slip. When a customer does not present his or her loyalty card, the till slip merely reflects the number of points that the customer could have earned had the customer presented the loyalty card. For ease of reference, I refer to all the

purchases in respect of which the customer earns points and without any redemption of the voucher as "*the first purchase and sale contract/s*".

[7] The appellant issues vouchers to all its customers who are members of the loyalty programme and who have earned 100 or more points. Typically a voucher will indicate a number of points accumulated and the rand value thereof. A customer is then able to redeem the voucher by purchasing goods equal to the rand value of the points indicated in the voucher. For ease of reference, I refer these purchases as "*the second purchase and sale contract/s*". There is also a hybrid of the first and second purchase and sale contract/s where the customer earns points in respect of that purchase and also redeems the voucher as part payment for the goods. These are however not relevant for the purposes of the determination of this matter.

[8] The appellant included amounts received of R58 550 602 in its gross income for tax purposes in the 2009 tax year. These amounts received had been disclosed as '*Loyalty card deferred income*' on the appellant's balance sheet for accounting purposes. The appellant claimed an allowance of R44 275 965 in terms of section 24C of ITA ("*the section 24C claim*"). Both the deferred income and the section 24C claim related to the loyalty programme. The section 24C claim was calculated on the value of loyalty card points the appellant expected to convert into free or discounted purchases in future.

[9] On 20 August 2013, the respondent disallowed the appellant's section 24C claim and raised an additional assessment contending that section 24C of the ITA is not applicable in respect of the loyalty programme in that:

> "9.1 The transaction whereby a customer purchases goods at an ABC store (and in terms of which income is received) gives rise to a separate contract to the loyalty programme;
>
> 9.2 The loyalty programme itself does not directly give rise to any income in the appellant's hands (it is free to join and there do not appear to be any hidden charges to members under the loyalty programme);
>
> 9.3 The appellant's obligation to award the member points based on qualifying sales and issue rewards when the specified number of points has been earned arises under the loyalty programme;
>
> 9.4 The appellant is likely to incur future expenditure when a customer redeems a reward and the appellant supplies the customer with goods equal to the value of the reward at no cost to the customer - this obligation to perform arises under the loyalty programme which is a different contract to that under which the income is received.

9.5 Section 24C only permits an allowance when income and the obligation to perform which will result in the appellant incurring future expenditure, arise under the same contract. In the present matter, the income and the obligation to perform arise under different contracts."

[10] The appellant filed an objection on 31 October 2013, and the respondent disallowed the appellant's objection on 12 February 2015. On 29 April 2015, the appellant lodged this appeal against the disallowance of its objection. The matter came before me on 22 May 2017 when it was postponed *sine die*. The matter came before me again on 14 August 2018 by which time the parties had managed to narrow the issues and advised the court that the only issue to be determined by this court is whether the appellant is entitled to an allowance of its section 24C claim having regard to the basis on which the respondent raised the assessment and disallowed same.

[11] The appellant contends that it is entitled to a deduction under section 24C in that:

11.1 In applying section 24C, it is artificial to regard the future expenditure the taxpayer will incur when a customer redeems a voucher as arising under a "*different contract*" to the first purchase and sale contract concluded with the same customer (i.e. and pursuant to which the points concerned were generated).

11.2 The first purchase and sale contract entered into pursuant to the loyalty card contract (i.e. on presentation of the loyalty card) cannot be treated as a completely separate contract from the loyalty card contract, given the close and inextricable connection between these two contracts.

[12] It is necessary to set out the provisions of section 24C at the time relevant to the assessment which is the subject of this appeal. At the relevant time section 24C stated that:

"**24C Allowance in respect of future expenditure on contracts—**(1) For the purposes of this section, 'future expenditure' in relation to any year of assessment means an amount of expenditure which the Commissioner is satisfied 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 by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilised in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under such contract, there shall be deducted in the determination of the taxpayers taxable income for such year such allowance (not exceeding the said amount) as the Commissioner may determine, in respect of so much of such future expenditure as in his opinion 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."

[13] The interpretation given by the courts to the provisions of section 24C is that for any allowance to qualify as a deduction under section 24C, the income must have been earned under the same contract as that from which the obligation to incur future expenditure arises. In ***ITC1667*** 61 SATC 439 ("*ITC1667*"), this court dealt with a claim for an allowance under section 24C where the taxpayer's obligation did not arise from the same contract from which the taxpayer derived the income. The taxpayer submitted that the two transactions form an integral part of the scheme which would never have taken place if one of the agreements had not been concluded and that it was artificial to draw a distinction between the two agreements. In rejecting this argument Blignault J stated the following at paragraph [13] "*In my view, however, Appellant's arguments are not valid. I do not think that it is helpful to describe the discounting transaction as an integral part of the scheme nor does it assist to look at the causal relationship between the agreements. The Legislature did not use the term 'scheme' or even 'transaction' in section 24C (2). The operative concert concept is 'contract'. It is a clear requirement of section 24C (2) of the Act that the expenditure must be incurred by the taxpayer in the performance of his obligations in terms of the same contract as the contract under which the income was derived by him or accrued to him. In my view, Appellant has failed to meet this requirement*."

[14] Galgut, J in ***ITC1697*** 63 SATC 146 ("*ITC1697*") also came to the same conclusion that the income must be earned from the same contract giving rise to the obligation to incur a future expenditure. At p 158 he stated that: "*Section 24C stipulates, as I have said, that for the allowance to be available, it must be in terms of the very contract in respect of which the income is received that the future expenditure is payable. The obvious case, for which the allowance in s 24C had been introduced, as I mentioned earlier, is one which arises in certain building contracts, where the owner pays the builder an amount in advance, where the builder's obligation to carry out the certain work in terms of the contract will give rise to expenditure which will only be incurred in a letter tax year.*"

[15] In ***ITC1890*** 19 SATC 62 *("ITC1890")*, Boqwana J, at para 19 stated it thus: "*From the wording of the section it is clear that the contract being evaluated must contain both income and the obligation of future expenses*."

[16] Whilst there is consensus in the authorities referred to above that the income must be earned from the same contract from which the obligations to incur future expenditure, this court in ***B v Commissioner for the South African Revenue Service*** (IT14240) [2017] ZATC 3 (3 November 2017) ("*IT14240*") upheld the taxpayer's appeal in circumstances where the income was not earned from the same contract giving rise to the obligation to incur future expenditure. In upholding the appeal the court approached the matter on the basis that the agreement which gave rise to the obligation to incur future expenditure was a *causa sine qua non* without which the appellant could not have been able to earn the income although the income was earned under different contracts. The court thus found there to be an "*inextricable link*" between the contracts from which the income was earned and the contract giving rise to the obligation to incur future expenditure.

[17] The appellant submitted that the loyalty card contract and the first purchase and sale contract are so "*inextricably linked*" that one cannot meaningfully separate the two – either factually or legally.

[18] Factually, it was submitted that:

18.1 The sole purpose of the loyalty card contract is to drive sales. It has no stand-alone purpose. Put differently, the sole object of the loyalty card contract is to bring about the first purchase and sale contract.

18.2 The loyalty card is issued pursuant to the loyalty card contract. In each and every one of the relevant first purchase and sale contracts, the customer presented his or her loyalty card at checkout and this is a significant factual tie-in between the loyalty card contract and the first purchase and sale contract.

18.3 The till-slip records not only the merchandise sold and the price, but also the number of points generated by the customer and this is a further significant factual tie-in between the two contracts. Thus, the sole documentary recordal of the first purchase and sale contract (i.e. the till-slip) records both the income generated by the appellant and the rewards earned under the transaction.

18.4 Put differently, both sides of the section 24C '*equation'* (i.e. income and future expenditure) are recorded when the first purchase and sale contract is concluded.

[19] The appellant further submitted that the loyalty card contract and the first purchase and sale contract are legally inextricably linked in that:

19.1 Firstly, the loyalty card contract regulates and gives content to the rights and obligations arising from the first purchase and sale contract. As appears from the till-slip, the obligations incurred by the appellant at the point of sale are not only to hand over the relevant merchandise, but also to issue points to the customer (one point for every R5 spent by the customer on the merchandise in question). The obligation to issue points has its origin in the loyalty card contract although it only becomes enforceable when the first purchase and sale contract is concluded.

19.2 Secondly, while the obligation to issue points is rooted in the loyalty card contract, the first purchase and sale contract is a necessary causal link for the awarding of points and hence the incurring of future expenditure. In this regard the appellant referred to paragraphs [34] and [35] of the judgment in IT14240, paragraphs 16.2 and 21 of respondent's Rule 31 statement. The appellant submitted that it is incorrect to say that that the appellant's future expenditure arises under the loyalty card contract and not under the first purchase and sale contract – since, without the first purchase and sale contract, no points are awarded and no future expenditure is incurred by the appellant.

19.3 Thirdly, the two contracts are between precisely the same parties (the appellant and the customer) and both contracts relate to precisely the same performance (or sets of performance). In substance, the appellant only ever renders one form of performance, *viz* the handover of merchandise to the customer; and the customer, in turn, only ever renders one form of performance, viz the payment of money (purchase price) to the appellant. In simple terms, when the appellant receives income (the purchase price) under the first purchase and sale contract, it knows that it will in future have to expend a certain proportion of that income, when it is called upon to provide free merchandise to the same customer from whom it received the income in question.

[20] The appellant submitted further that the fact that the two contracts are between the same parties and are directed at the same performance (or sets of performance) means that the appellant's case in this matter is significantly stronger than the (successful) taxpayer's case in ***IT14240*** (where the two contracts were between different parties), and that this is *par excellence* a case for the application of section 24C. This was contrasted with ***ITC 1890*** where the court was dealing with two contracts with different parties, and where the taxpayer

received income from party A under contract I, but incurred expense *vis-à-vis* party B under contract II where the court held at paragraphs [25], [29] and [32] that the non-identity of parties was *"an important issue*" in finding that the two contracts were not sufficiently linked. The applicant also contrasted this matter with ***ITC1667*** where the court's finding at paragraph [13] that the relevant maintenance agreement was "*legally independent and separate from"* the discounting agreement was based on the fact that the taxpayer concluded the agreements with different parties.

[21] The respondent's main submission was that in order for the appellant to be entitled to claim an allowance under section 24C of the ITA the income received, and the obligation to incur the future expenditure sought to be deducted, must arise from the same contract. In this regard the respondent relied on the line of authorities which upheld this interpretation of section 24C (See: ***ITC1667***, ***ITC1697*** and ***ITC1890***).

[22] The respondent's counsel submitted that the *obiter dictum* of Cloete J in ***ITC14240*** at paragraph 54 that section 24C does not necessarily require one contract only, is wrong, and does not tie up with the wording of section 24C (i.e. "*future expenditure which will be incurred by the taxpayer in the performance of the taxpayer's obligations under such contract…".*

[23] He submitted further that in any event ***ITC14240*** is distinguishable on the facts. In ***ITC14240*** the appellant was a franchisee of a restaurant. In terms of the franchise agreement, the appellant was obliged to incur future expenditure for the maintenance and upgrade of the restaurant. The appellant sought to deduct those future expenditure from income derived from the sale of meals to customers. The court found that the "*proximate cause*" of both the income and the obligation to incur future expenditure was the franchise agreement and thus, the learned Judge held: "*In the present matter the sale of meals is not triggered by the conclusion of the franchise agreement in the sense that such sales are merely an independent separate consequence thereof. If that were the case, the franchise agreement would not contain a clause that a failure by the taxpayer to sell meals to its customers is a material breach entitling the franchisor to cancel. Put bluntly, no sales means no franchise agreement at the franchisor's sole election*."

[24] Respondent's counsel pointed out that in the present case, it is the conclusion of the first and second purchase second contracts that are "*trigger events*" or contingent events upon which the allocation of points (which does not result in income) or the third agreement of purchase and sale (which gives rise to both income and discount). The loyalty card agreement, which is the *forms et origo* of the obligation to afford a discount is not a prerequisite or as it was put in ***ITC14240*** by Cloete J, "*inextricably interwoven*" with the income.

[25] It was also submitted on behalf of the respondent that in any event Cloete J, was clearly misdirected when she found in paragraph [54] that: "*What was so implicitly recognised in ITC1667, is that there does not physically have to be one contract document in order to give rise to the section 24C benefit. Hence the Court's assumption that the rental and maintenance agreements constitute one single contract for purposes of the application of section 24C*."

[26] Respondent's counsel in this regard directed this court's attention to paragraph [13] of the judgment in ***ITC 1667*** where Blignault J said: "*In my view, however, Appellant's arguments are not valid. I do not think that it is helpful to describe the discounting transaction as an integral part of the scheme nor does it assist to look at the causal relationship between the agreements. The Legislature did not use the term 'scheme' or even 'transaction' in section 24C(2). The operative concert concept is 'contract'. It is a clear requirement of section 24C(2) of the Act that the expenditure must be incurred by the taxpayer in the performance of his obligations in terms of the same contract as the contract under which the income was derived by him or accrued to him. In my view, Appellant has failed to meet this requirement*."

[27] To sum up respondent's counsel submitted that on the facts of this matter three different contracts that can be discerned, namely

(a) the loyalty card agreement, concluded free of charge, from which no income is derived and from no obligation to incur future expenditure arises (the loyalty card contract);

(b) the first sale agreement from which income is derived but from which no liability to incur future expenditure arises (the first purchase and sale contract); and

(c) the third contract of purchase and sale which simultaneously earns income for the appellant and creates a liability on the appellant to grant the customer a predetermined credit or discount (the second purchase and sale contract).

[28] The textual analysis of section 24C of ITA is set out as follows in the heads of argument filed on behalf of the appellant, namely: "*a particular deduction is allowed if two requirements are met. If:*

1.1. the income of the taxpayer in a year of assessment includes or consists of an amount received by or accrued to him in terms of any contract; and

1.2. the Commissioner is satisfied that such amount will be utilised in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under such contract,

then,

in determining the taxpayer's taxable income for such year, there shall be deducted an allowance in respect of so much of the future expenditure as relates to the said amount."

[29] Thus from a textual reading of section 24C of ITA, a taxpayer will be able to claim a deduction under section 24C where income is earned under a contract that obliges the taxpayer to incur expenditure in future years.

[30] The initial position taken by the respondent was that the appellant's section 24C claim did not meet the requirements of section 24C in that the income was earned under the first or second purchase and sale contract whilst the obligation to incur expenditure in the future arose under the loyalty card agreement. This was pleaded as follows in the respondent's Rule 31 statement "*The appellant is likely to incur future expenditure when a member redeems a reward and the appellant supplies the member with goods equal to the value of the reward at no cost to the member. In short, this obligation to perform arises under the loyalty programme which is a different contract to that under which the income is received."*

[31] As appears in paragraph [27] above, the respondent's position has changed slightly in that the respondent's position now is that no income is derived from the loyalty card and no obligation to incur future expenditure arises from the loyalty card. The respondent's changed stance is consistent with the facts. Factually, no income is earned upon the conclusion of the Loyalty card contract. Also no obligation to incur future expenditure arises upon the conclusion of the loyalty card contract. The loyalty card contract merely records the terms upon which the appellant is to reward the loyalty card holders in respect of their future purchases.

[32] The respondent, however, maintains that no obligation to incur future expenditure arises when the first purchase and sale contract is concluded. The respondent's view is that only income is earned at this stage without any concomitant obligation to incur future expenditure. This, in my view, is not factually correct. As will be recalled when the customer concludes the first purchase and sale contract with a spend of R10 or more the appellant awards the customer points which the customer may redeem in the future.

[33] In my view, the conclusion of the first purchase and sale contract results in two things, namely

(a) the appellant earns income, and

(b) the appellant incurs an obligation to incur future expenditure towards the customer. The obligation to incur future expenditure arises from the fact that the appellant will in future be obliged to provide goods to the customer when the customer redeems his or her voucher. At this stage the appellant is aware of its obligation to the customer. Thus, I cannot agree that no obligation to incur future expenditure arises from the first purchase and sale contract.

[34] What the respondent refers to as "*the third agreement of purchase and sale which simultaneously earns income for the appellant and creates a liability on the appellant to grant the customer a predetermined credit or discount*", appears to be the transaction by which the customer redeems the voucher and which I have referred to as the "*second purchase and sale contract*". If the second purchase and sale contract comprises of only the redemption of a voucher, the appellant does not earn an income. In this scenario the appellant only incurs the actual expenditure in respect of the obligation which arose upon the conclusion of the first purchase and sale contract.

[35] The appellant's section 24C claim is not based on the expenditure it incurs upon the conclusion of the second purchase and sale contract. This is so because section 24C is only available in respect of future expenditure. In this instance where the actual expenditure has been incurred, the appellant can only rely on section 11 to claim such a general deduction.

[36] I agree with the appellant's submission that it is artificial to regard the future expenditure the taxpayer will incur when a customer redeems a voucher as arising under a "*different contract*" to the first purchase and sale contract concluded with the same customer (i.e. and pursuant to which the points concerned were generated). In fact, in my view, it is not only artificial to do so but it is factually incorrect. The first purchase and sale agreement incorporates the terms of the loyalty card contract. Despite that the first purchase and sale contract remains the contract that triggers both the earning of income by the appellant as well as an obligation by the appellant to incur future expenditure.

[37] Based on the finding that the income is earned on the same contract that gives rise to the obligation to incur future expenditure, it follows that the appellant's section 24C claim meets the requirements of section 24C.

[38] It was also argued on behalf of the respondent that the appeal should fail because the obligation to incur future expenditure was a contingent liability as the appellant has not succeeded in discharging the *onus* resting upon it to convince the court that there was a sufficient measure of certainty that the expenditure will be incurred due to the fact that such obligation only arose if triggered by the customer when making a second purchase.

[39] The respondent's difficulty with this submission is that this was not the basis upon which the respondent disallowed the appellant's section 24C claim. This was also not pleaded in the respondent's Rule 31 statement.

[40] The parties have also agreed that in the event of it being found that the appellant's section 24C claim meets the requirements of section 24C, the respondent shall partially allow the appellant's objection to the disputed assessment, and revise the allowance, which shall then be calculated in accordance with the table set out in paragraph 37 of the respondent's disallowance of objection, as follows:

"Deferred income	*58 550 602*
Less:	
Members not qualified	*(3 580 416)*
Customers not registered	*(2 016 056)*
Unreconciled difference	*(3 576 966)*
Balance of deferred income	*49 377 164*
Less:	
Amount related to credit cards (3%)	*(1 481 315)*
Amount related to Affinity Partners	*(XXX)***
Balance of deferred income	*47 895 849*
Revised section 24C allowance based on application of Gross Profit percentage (24.38%)	*36 218 841*

*** Amount to be determined by Taxpayer. Amount represents balance of deferred income attributable to customer spend at Affinity Partners."*

[41] In view of what I have stated in paragraphs [39] and [40] above, it is, in my view, impermissible for the respondent to argue the point relating to contingent liability. It was never raised, never pleaded and the *quantum* is not in dispute. In my view, the appeal should succeed. Neither of the parties asked for a costs order and in the circumstances the following order is made:

41.1 The appeal succeeds and there is no order as to costs.

41.2 The respondent is directed to partially allow the appellant's section 24C claim and revise the allowance in accordance with the table set out in paragraph [40] above.

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NUKU, J