

**DRAFT INTERPRETATION NOTE 78 (Issue 2)**

DATE:

**ACT : INCOME TAX ACT 58 OF 1962**  
**SECTION : SECTION 24C**  
**SUBJECT : ALLOWANCE FOR FUTURE EXPENDITURE ON CONTRACTS**

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### **Preamble**

In this Note unless the context indicates otherwise –

- “**advance income**” means income, received by or accrued to a taxpayer under a contract, that will be used to finance the expenditure still to be incurred in fulfilling the taxpayer’s obligations under that contract;
- “**section**” means a section of the Act;
- “**section 24C allowance**” means an allowance under section 24C of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962;
- “**the TA Act**” means the Tax Administration Act 28 of 2011; and
- any other word or expression bears the meaning ascribed to it in the Act.

## **1. Purpose**

This Note provides guidance on the interpretation and application of section 24C when income is received in advance while the expenditure under the contract will only be incurred in a subsequent year of assessment.

## **2. Background**

Section 5 provides that income tax is payable annually. An amount that is received by or accrued to a taxpayer in a particular year of assessment must be included in the taxpayer’s gross income unless it is of a capital nature. The nature of some 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 the future in performing under that contract. Generally, expenditure must be actually incurred before a deduction can be allowed [for example, section 11(a)] and, in addition, section 23(e) specifically prohibits the deduction of income carried to any reserve fund or capitalised in any way. An anomaly therefore arises when income is received in one year and the related expenditure is incurred in a subsequent year of assessment.

Section 24C was inserted in the Act<sup>1</sup> as a relief measure to taxpayers that, because of the nature and special circumstances of their businesses, receive advance income during a year of assessment but only incur related expenditure in a subsequent year of assessment. The explanatory memorandum explains the reason for the insertion of section 24C as follows:<sup>2</sup>

“The new section caters for the situation which often arises in the construction industry and sometimes in manufacturing concerns, where a large advance payment is made to a contractor before the commencement of the contract work, to enable the contractor to purchase materials, equipment etc. In a number of instances such advance payments are not matched by deductible expenditure, resulting in the full amounts of the advance payments being subject to tax.”

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<sup>1</sup> Section 18(1) of the Income Tax Act 104 of 1980.

<sup>2</sup> *Explanatory memorandum on the Income Tax Bill, 1980.*

Although section 24C was originally intended for taxpayers entering into building and manufacturing contracts, it does not mean that the section cannot be applied to taxpayers entering into other types of contracts. In ITC 1697<sup>3</sup> *Galgut J* stated the following:

“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. . . .”

Section 24C has been and can be applied to businesses in industries other than building and manufacturing provided the detailed requirements of the section are met. For example, the section has been applied to the motor industry, the financial services industry, publishers, share block schemes and the retail sector.

Section 24C was amended in 2015<sup>4</sup> to remove the Commissioner’s discretion under the section. Much of the case law relating to section 24C dealt with the exercise of the Commissioner’s discretion regarding specific requirements under the section. These cases, however, remain relevant as guidance to the correct application and computation of the allowance, as set out in the Note, since the requirements are the same notwithstanding the deletion of the Commissioner’s discretion.

An assessment of whether section 24C applies must be performed annually taking up-to-date information into account.

Section 24C is subject to objection and appeal in accordance with Chapter 9 of the Tax Administration Act, 2011.<sup>5</sup>

### 3. The law

#### Section 24C

**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 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 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.

<sup>3</sup> (1999) 63 SATC 146 (N) at 155.

<sup>4</sup> Section 42 of the *Taxation Laws Amendment Act 25 of 2015*.

<sup>5</sup> Sections 104 and 107, respectively.

#### 4. Application of the law

The deduction of an allowance is permitted under section 24C if all of the following requirements are met:

- Income (see **4.1**) for the particular year of assessment includes or consists of an amount which is received or accrued under any contract (see **4.1.1**).
- The amount received or accrued will be used in whole or in part to finance expenditure (see **4.2.1(a)**) which will be incurred by the taxpayer in a subsequent year of assessment (see **4.2.1(b)**) in performing the obligations under such contract [see **4.2.1(c)**].
- That expenditure must either be expenditure which will be allowed as a deduction from income when incurred in a subsequent year of assessment (see **4.2.3**) or is expenditure which will be incurred in a subsequent year of assessment on the acquisition of an asset (see **4.2.4**) for which any deduction will be allowed under the Act (“future expenditure”).

Section 24C(3) stipulates that an allowance deducted in any year of assessment is deemed to be income in the succeeding year of assessment.

The requirements and the calculation of the amount of the allowance are considered in the paragraphs that follow.

##### 4.1 Income

A prerequisite for any allowance under section 24C is that the taxpayer concerned must have included an amount, which was received or accrued under any contract, in income in the year of assessment in which the allowance is claimed.

It is considered likely that in most circumstances advance income will arise when an amount has been received in advance and not when the amount has accrued to the taxpayer before being received. Accordingly, for ease of reference throughout this Note reference is made to the receipt of an amount and not to the accrual of an amount. However, if circumstances arise in which an amount of advance income accrues before being received, the principles discussed in this Note will apply.

The term “income” is defined in section 1(1) as –

“the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II;”

This Note does not consider the requirements for an amount to constitute gross income<sup>6</sup> and whether a particular amount constitutes gross income or exempt income.<sup>7</sup> However, two amounts require consideration, namely –

- actual amounts which are received or have accrued under the contract; and

<sup>6</sup> Defined in section 1(1).

<sup>7</sup> For example, section 10(1).

- the reversal of the prior year's section 24C allowance.<sup>8</sup>

The reversal of the prior year's section 24C allowance and deemed inclusion in income is income received under the contract. A further deduction of the section 24C allowance may therefore be allowed against the reversal in the succeeding year of assessment if, after the end of that succeeding year of assessment, there is still future expenditure which will be incurred.

Therefore, in assessing whether an amount of income received or accrued in a particular year of assessment will be used to finance future expenditure, the amount of income will include actual amounts under the contract which are included as income in the particular year of assessment as well as the reversal of the prior year's section 24C allowance.

### Example 1 – Income

#### *Facts:*

In the first year of assessment (year 1) Company C received advance income of R1 000 000. The total estimated expenditure to be incurred in future was R600 000 and a section 24C allowance of R600 000 was permitted.

In the second year of assessment (year 2) no additional amounts were received by or accrued to Company C under the contract. Company C did not incur any expenditure in year 2 but because of unexpected cost escalations total estimated expenditure increased to R800 000.

#### *Result:*

#### **Year 1**

	R
Gross income	1 000 000
Less: Section 24C allowance allowed in year 1	<u>(600 000)</u>
Taxable income	<u>400 000</u>

#### **Year 2**

Section 24C allowance allowed in year 1	600 000
Less: Section 24C allowance allowed in year 2	<u>(600 000)</u>
Taxable income	<u><u>NIL</u></u>

The amount of income in year 2 which is relevant for purposes of section 24C is R600 000. The maximum section 24C allowance which may be granted is therefore limited to R600 000 (see 5.2 for a consideration of this aspect) even though future expenditure is estimated to be R800 000.

<sup>8</sup> Deemed income under section 24C(3) and paragraph (n) of the definition of the term "gross income".

**Note:** In different circumstances, if Company C had received additional amounts under the contract in year 2 these additional amounts would also have been included in the amount of income relevant for purposes of section 24C. The inclusion of additional contract revenue would mean that all or some of the additional estimated contract expenditure of R200 000 would potentially qualify for the section 24C allowance. The allowance in year 2 would be limited to the income recognised in year 2 which would comprise the additional contract revenue received in year 2 plus the section 24C allowance allowed in year 1 which reversed and was included in income in year 2.

#### 4.1.1 A contract

Section 24C requires that the amount of income must be received by or accrued to a taxpayer under any contract. The word “contract” is not defined in the Act and therefore the ordinary meaning of the word must be applied. A “contract” is defined in the Law of South Africa<sup>9</sup> as –

“an agreement entered into with the intention of creating a legal obligation or obligations”.

In order for a contract to be valid –<sup>10</sup>

“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.”

Although there is no specific requirement that a contract must be constitutionally valid, public policy requires that the Constitution and its values must be taken into account when considering whether a contract is lawful.<sup>11</sup> Constitutional validity of a contract is therefore indirectly required.

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.<sup>12</sup>

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 future expenditure related to performing those obligations.<sup>13</sup> SARS recognises that not all contracts are reduced to writing, for example, certain implicit unilateral contracts

<sup>9</sup> ADJ Van Rensburg *et al* “Contract” (Volume 9 - Third Edition) LAWSA [online] (My LexisNexis: 31 October 2014) in paragraph 295.

<sup>10</sup> ADJ Van Rensburg *et al* “Contract” (Volume 9 - Third Edition) LAWSA [online] (My LexisNexis: 31 October 2014) in paragraph 328.

<sup>11</sup> ADJ Van Rensburg *et al* “Contract” (Volume 9 - Third Edition) LAWSA [online] (My LexisNexis: 31 October 2014) in paragraph 328.

<sup>12</sup> ADJ Van Rensburg *et al* “Contract” (Volume 9 - Third Edition) LAWSA [online] (My LexisNexis: 31 October 2014) in paragraph 340.

<sup>13</sup> Section 102 of the TA Act.

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.

## 4.2 Future expenditure

For purposes of section 24C, future expenditure is expenditure which will be incurred by the taxpayer in a subsequent year of assessment in performing the taxpayer's obligations under the contract<sup>14</sup> in such a manner that the expenditure –

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

### 4.2.1 Expenditure which will be incurred in a subsequent year of assessment in performing the taxpayer's obligations under the contract

#### (a) Expenditure

The word “expenditure” is not defined in the Act; however, it has been considered in a number of court cases, some of which will be considered below. In considering what constitutes expenditure it is also important to distinguish expenditure from “losses”; the two are different and section 24C only applies to future expenditure.

The *Collins Dictionary* defines “expenditure” and “loss”, respectively as follows:

“Expenditure is the spending of money on something, or the money that is spent on something.”<sup>15</sup>

“Loss is the fact of no longer having something or having less of it than before.”<sup>16</sup>

In *Joffe & Co (Pty) Ltd v CIR*,<sup>17</sup> Watermeyer CJ explained the distinction between the words “loss” and “expenditure” 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.”

A similar distinction was drawn between “disbursements” or “expenses” on the one hand and “losses” on the other in the English case of *Allen (HM Inspector of Taxes) v Farquharson Brothers and Co*,<sup>18</sup> in which Findlay J explained that the word “disbursements” –

“means something or other which the trader pays out; I think some sort of volition is indicated. He chooses to pay out some disbursement; it is an expense; it is something which comes out of his pocket. A loss is something different. That is not a thing which he expends or disburses. That is a thing which, so to speak, comes upon him *ab extra*.”

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<sup>14</sup> Performing under the contract is not part of the definition of the term “future expenditure” in section 24C(1) but an interlinked requirement noted in section 24C(2).

<sup>15</sup> [www.collinsdictionary.com/dictionary/english/expenditure](http://www.collinsdictionary.com/dictionary/english/expenditure) [Accessed on 21 July 2023].

<sup>16</sup> [www.collinsdictionary.com/dictionary/english/loss](http://www.collinsdictionary.com/dictionary/english/loss) [Accessed on 21 July 2023].

<sup>17</sup> 1946 AD 157, 13 SATC 354 at 360.

<sup>18</sup> 17 TC 59 at 64.

In *COT v Rendle*<sup>19</sup> Beadle CJ distinguished between “designed expenditure” and “fortuitous expenditure” as follows:

“For the purposes of this case, expenditure incurred for the purpose of trade may be grouped broadly under two heads. First, money voluntarily and designedly spent by the taxpayer for the purpose of his trade; and second, money which is what I might call involuntarily spent because of some mischance or misfortune which has overtaken the taxpayer. For the sake of convenience, I will refer to the first type of expenditure as ‘designed expenditure’, and to the second as ‘fortuitous expenditure’.”

In *C: SARS v Labat Africa Ltd*<sup>20</sup> the Supreme Court of Appeal was also called upon to consider whether there had been any expenditure when the purchase price for a trademark, which was acquired as part of the acquisition of a business, was settled by the taxpayer issuing its own shares. The court held that irrespective of the fact that the issue of shares for the acquisition of assets amounted to ‘consideration’ given by the company and that the consideration appeared to be fairly valued, there had been no expenditure. Harms AP noted that –<sup>21</sup>

“[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.”

In *Ackermans Ltd v C: SARS*<sup>22</sup> 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:<sup>23</sup>

“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

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<sup>19</sup> 1965 (1) SA 59 (SRAD), 26 SATC 326 at 329.

<sup>20</sup> 2013 (2) SA 33 (SCA), 74 SATC 1.

<sup>21</sup> 74 Above 21 at 6 (paragraph 12).

<sup>22</sup> 2010 (1) SA 1 (SCA), 73 SATC 1.

<sup>23</sup> At 5 and 6.



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.”

A taxpayer seeking to claim a section 24C allowance will not have incurred the expenditure at the end of the year of assessment. However, the taxpayer bears the *onus* of proving<sup>24</sup> that the expenditure will be incurred in a subsequent year of assessment – this aspect is considered further in **4.2.1(b)**.

**(b) Will be incurred in a subsequent year of assessment**

Applying the meaning of expenditure considered in **4.2.1(a)** to section 24C, a taxpayer 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, for that expenditure to meet the “will be incurred in a subsequent year of assessment” requirement.

The words “will be incurred” indicate that there must be a high degree of probability and inevitability that the expenditure will be incurred by the taxpayer. A taxpayer must therefore be able to demonstrate that, although the expenditure is contingent at the end of the year of assessment in question, there is a high degree of certainty that the expense will in fact be incurred in a subsequent year.

The position was explained in ITC 1601<sup>25</sup> as follows:

“Counsel for the Commissioner, in my view, correctly contended that the Commissioner will not be satisfied that future expenditure will be incurred where there is only a contingent liability. There must be a clear measure of certainty as to whether the expenditure in contention is quantified or quantifiable. The *onus* that the appellant bears here is to satisfy the Commissioner that the agreements relied upon will lead to deductible expenditure, in the following year. The appellant’s contention that the use of the word ‘will’ relates only to time and not to the certainty of the expense, cannot in my view be correct. Since a deduction is sought, this must arise from an obligation and must be quantifiable.

It was also, in my opinion, correctly submitted that s 24C was not enacted to provide a deductible reserve fund for possible ‘comebacks’, unforeseen contingencies or latent defects in the *res vendita*. This would be contrary to the provisions of s 23(e) of the Act

...

...

S24C is an exception to the general rule and as such the court, having regard always to its specific ambit is entitled to take a strict rather than a liberal view in its application to the facts in issue. The Commissioner, provided he too has full regard to the available facts, is entitled to adopt the same approach in exercising his discretion.”

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<sup>24</sup> Section 102 of the TA Act.

<sup>25</sup> (1995) 58 SATC 172 (C) at 179.

The facts and circumstances of each case vary significantly and it is therefore not possible to specify the industries or particular circumstances in which taxpayers will always be able to demonstrate and prove the required level of certainty. The facts of each case are critical. However, the degree of certainty required is unlikely to be met if the performance is *not* contractually obligatory but is only *potentially* contractually obligatory because of an act or event other than just the taxpayer's client or customer taking action.

The distinction can be a fine one. For example, in the case of a construction contract under which a builder is contractually required to build a house which includes tiling the floors (that is, performance is obligatory), the cost of the tiles will be included in the future expenditure calculation. The degree of certainty required that the expenditure will be incurred exists in such a situation. The fact that the client has not yet decided on, for example, the colour of the tiles at the end of the year of assessment does not *per se* disturb the degree of certainty although it may affect the quantification of the amount of future expenditure if the cost of the tiles is dependent on the colour chosen.

Generally, an obligation to perform remains unconditional when performance is merely dependent on the client taking action (for example, the client choosing the colour of the tiles) but not when performance is dependent on further events which may or may not occur.

The application of the concept of "certainty" in relation to warranties and maintenance contracts is considered in **4.2.6** and **4.2.7**. At a principle level, whether the costs are variable or fixed or of an operational or infrastructural nature is not critical; what is important is that the costs flow from an unconditional obligation to perform<sup>26</sup> under the contract which gave rise to the advance income and that the expenditure will be incurred in a subsequent year of assessment. Each case must be considered on its own facts.

A taxpayer will not discharge the *onus* of proof<sup>27</sup> that future expenditure will be incurred after a point in time when a taxpayer's obligation to perform falls away at that point in time. However, even if the taxpayer's obligation to perform has not legally fallen away, it may happen that at some point in time the taxpayer will be unable to prove that the required performance under the contract will be delivered and under such circumstances the requirement that future expenditure will be incurred will not be met by the taxpayer.

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<sup>26</sup> An unconditional obligation to perform does not mean the taxpayer has unconditionally incurred the expenditure, the expenditure will only be incurred when the taxpayer actually performs.

<sup>27</sup> As envisaged in section 102 of the TA Act.

**(c) In performing the taxpayer's obligations under the contract in terms of which the income was received**

The future expenditure must be incurred by the taxpayer in the performance of the taxpayer's obligations under the same contract as the contract under which the income was received by or accrued to the taxpayer<sup>28</sup> or under two or more contracts which are "so inextricably linked" that they satisfy this requirement of "sameness" under section 24C.<sup>29</sup> The contract does not have to (and rarely will) stipulate the exact expenditure that the taxpayer will incur. However, the taxpayer's obligations under the contract must be apparent or determinable and it is the expenditure which the taxpayer will incur in performing and meeting those obligations which is of relevance.

In ITC 1667<sup>30</sup> the taxpayer entered into rental and maintenance agreements (which the court assumed, without deciding, were one contract) 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 (that is, maintaining the copy machines) was not under the same contract under which the lump sum income was received.

In ITC 1697<sup>31</sup> the taxpayer, a share block company, received up-front levy income<sup>32</sup> 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 immovable 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<sup>33</sup> 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 (that is, the contract under which the income arose) and did not therefore qualify for a section 24C allowance.

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<sup>28</sup> ITC 1667 (1999) 61 SATC 439 (C); ITC 1697 (1999) (1999) 63 SATC 146 (N); ITC 1527 (1991) 54 SATC 227 (T); ITC 1890 (2016) 79 SATC 62(C); *C: SARS v Big G Restaurants (Pty) Ltd* 2019 (3) SA 90 (SCA), 81 SATC 185 and *C: SARS v Clicks Retailers (Pty) Ltd* 2020 (2) SA 72 (SCA), 82 SATC 167.

<sup>29</sup> *Big G Restaurants (Pty) Ltd v C: SARS* 2020 (6) SA 1 (CC), 82 SATC 403 and *Clicks Retailers (Pty) Ltd v C: SARS* 2021 (4) SA 390 (CC), 84 SATC 71.

<sup>30</sup> (1999) 61 SATC 439 (C).

<sup>31</sup> (1999) 63 SATC 146 (N).

<sup>32</sup> Under the applicable legislation at the time, section 24C was relevant to the determination of the exemption of exempt income under section 10(1)(e) and the off-setting of "losses" against other income.

<sup>33</sup> (1991) 54 SATC 227 (T).

In ITC 1890<sup>34</sup> the contract of sale utilised in a retirement village arrangement was a tripartite agreement between the resident seller, the purchaser and the retirement village managing agent (the Appellant). The contract of sale provided, amongst others, that 1) in the event of a resale by the purchaser the Appellant was entitled to 40% of the enhancement in value and the purchaser (being the future re-seller) was entitled to the original purchase price plus 60% of the enhancement in value, and 2) that the Appellant would subsidise the monthly levy as specified in the contract of sale payable by the purchaser. The Appellant argued that the entitlement to the enhancement in value arose under the future re-sale agreement and that in terms of that agreement the Appellant had future expenditure in the form of the subsidised levy it had to pay for the future purchaser in the re-sale agreement. The Court disagreed and found that:

- there were two agreements (the contract of sale and the future re-sale agreement);
- that the Appellant's entitlement to the 40% enhancement in value arose under the contract of sale even though it was only triggered when a re-sale took place under the future re-sale agreement;
- that there was no future expenditure in terms of the contract of sale at the time the entitlement to 40% enhancement in value was triggered in the future, since any subsidised levy expense in relation to that purchaser had already been incurred; and
- that the future expenditure in the form of future subsidised levy payments payable in relation to the future purchaser under the future resale agreement arose under a separate agreement (the future resale agreement) and did not relate to the receipt of the 40% enhancement in value which arose under the contract of sale.

Accordingly, the taxpayer was not entitled to an allowance under section 24C.

In *Big G Restaurants (Pty) Ltd*<sup>35</sup> and *Clicks Retailers (Pty) Ltd*,<sup>36</sup> the Supreme Court of Appeal ("SCA") confirmed that the future expenditure in relation to which the section 24C allowance was sought, was required to be incurred in performance of obligations incurred under the same contract as the contract under which the advance income was received or accrued. Otherwise stated, the income received or accrued and the obligation to perform must be under the same contract. The Constitutional Court went further and held that the "sameness" requirement could be met in cases involving two or more contracts if the contracts were "so inextricably linked", however, on the facts of both those cases the relevant contracts were found not to be so inextricably linked as to meet the sameness requirement. In *Clicks Retailers (Pty) Ltd*,<sup>37</sup> the Constitutional Court clarified that it was not sufficient for two contracts to be inextricably linked, it was necessary to demonstrate that the contracts were "so inextricably linked" that they meet the requirement of "sameness". Neither of the Constitutional Court judgements provided comprehensive commentary on circumstances in which two or more contracts would be regarded as being "so inextricably linked" so as to meet the "sameness" requirement in section 24C.

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<sup>34</sup> (2016) 79 SATC 62 (C).

<sup>35</sup> *C: SARS v Big G Restaurants (Pty) Ltd* 2019 (3) SA 90 (SCA), 81 SATC 185; *Big G Restaurants (Pty) Ltd v C: SARS* 2020 (6) SA 1 (CC), 82 SATC 403.

<sup>36</sup> *C: SARS v Clicks Retailers (Pty) Ltd* 2020 (2) SA 72 (SCA), 82 SATC 167; *Clicks Retailers (Pty) Ltd v C: SARS* 2021 (4) SA 390 (CC), 84 SATC 71.

<sup>37</sup> *Clicks Retailers (Pty) Ltd v C: SARS* 2021 (4) SA 390 (CC), 84 SATC 71.

This is an aspect which will have to be determined based on the facts of a particular case. In the *Clicks Retailers (Pty) Ltd*<sup>38</sup> Constitutional Court judgement, the court held that at a minimum both the earning of income and the obligation to fund future expenditure must depend on the existence of both contracts and if either can be entered into and exist without the other then contractual sameness cannot be achieved. Having regard to these judgments (considered in more detail below), what is clear is that it is insufficient for a contract under which the advance income arises to merely be linked in some way to a contract under which the taxpayer has an obligation to perform, something more is required. In summary, the income received or accrued and the obligation to perform, and in so doing incur future expenditure, must be under the same contract, or under two or more contracts which are “so inextricably linked” that they satisfy the requirement of “sameness” under section 24C.

In *C: SARS v Big G Restaurants (Pty) Ltd*<sup>39</sup> the taxpayer was a franchisee operating a number of Spur and Panarottis restaurants under franchise agreements concluded with the franchisor, Spur Group (Pty) Ltd. Under the franchise agreements the taxpayer was, amongst others, required to refurbish its restaurants at reasonable intervals as determined by the franchisor. In its 2011 to 2014 years of assessment, the taxpayer claimed certain amounts under section 24C relating to future expenditure to be incurred by virtue of the obligation imposed by the franchise agreements to upgrade and refurbish its restaurants.

The court was asked to decide two questions of law. The first was whether the income received by the taxpayer from operating the franchise business were amounts received or accrued in terms of the franchise agreement as envisaged in section 24C. The second was whether the expenditure required to refurbish or upgrade restaurants was incurred “*in the performance of the taxpayer’s obligations under such contract*”, as contemplated in section 24C.

Schippers JA, in a unanimous judgement, held that section 24C has two basic requirements. Namely, 1) income must be received or accrued in terms of a contract and 2) the income received from the contract will be used wholly or partially to finance future expenditure that a taxpayer will incur in performing its obligations under that same contract. Further that there is a direct and immediate connection between these two requirements and different income-earning and obligation-imposing contracts are not permitted.

The obligation to undertake future refurbishments arose under the franchise agreement and the issue was therefore whether “in terms of” in “income received by or accrued ... in terms of any contract” must be interpreted widely or narrowly. The taxpayer contended that it must be interpreted widely and, on that basis, because the franchise agreement entitled the franchisee to run the business and obligated them to do so or risk the agreement being cancelled, that the source of the income (being the amount charged to patrons for food in the patron contract) was the franchise agreement. Accordingly, the taxpayer argued that the income was received in terms of the franchise agreement. The court disagreed and found that the narrow meaning of “in terms of” was required and was supported by the context and background to the provision. Schippers JA held that section 24C constituted an exception to the general prohibition contained in section 23(e), which provides that no deduction shall in any

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<sup>38</sup> *Clicks Retailers (Pty) Ltd v C: SARS* 2021 (4) SA 390 (CC), 84 SATC 71.

<sup>39</sup> 2019 (3) SA 90 (SCA), 81 SATC 185.

case be made in respect of income carried to any reserve fund or capitalised in any way.

Applying the narrow meaning, the court held the taxpayer earned income in terms of each contract concluded with patrons and not in terms of the franchise agreement. The franchise agreement did not contain any rights to income. Income was therefore not received or accrued in terms of the franchise agreement as envisaged in section 24C.

The taxpayer also argued that the franchise agreement and the patron contract were inextricably linked and that both agreements required the taxpayer to sell meals to patrons and in so doing earn income, with the result that the proximate cause of the sales income was the obligation under the franchise agreement to sell meals. The court disagreed with this argument and found it to be another way of arguing for a wide interpretation of “in terms of any contract”. The court pointed out that the fact that a contract is useful or even necessary to enable a taxpayer to earn income does not mean that its income is earned ‘in terms of’ such contract. So, for example, in the current case the fact that the franchise agreement was required in order for the taxpayer to operate the business and therefore be able to sell meals to patrons did not mean the income was earned in terms of the franchise agreement, the income was earned in terms of the patron agreement. The franchise agreement and the patron agreement were not inextricably linked. Another example would be a lease agreement for commercial premises, the fact that the premises are required from which to run a business and be in a position to conclude sales contracts does not mean the sales income is earned in terms of the lease agreement, it is earned in terms of a sales agreement which is a separate agreement.

The court’s conclusion on the first question of law was dispositive of the appeal. Consequently, it was unnecessary to decide the second question.

The Constitutional Court in *Big G Restaurants (Pty) Ltd v C: SARS*<sup>40</sup> agreed that section 24C(2) requires that the contract in terms of which the income that is to be used to finance future expenditure is received or accrues must be the same contract as the contract under which the obligation to perform, and in so doing incur future expenditure, arises. However, it held the sameness requirement did not mean that, for example, in the case of a written contract, there had to be one piece of paper stipulating both the income and imposition of future expenditure. It noted that two or more contracts may be “so inextricably linked” that they may satisfy this requirement of “sameness”. The Constitutional Court found the obligation to perform the refurbishments and thus incur future expenditure arose under franchise agreement whilst the income arose under the sale of food contracts with the patrons. Further, there was a lack of correlation between the two contracts, which by implication meant the two contracts were not “so inextricably linked” so as to meet the “sameness” requirement in section 24C and, accordingly, section 24C was not applicable.

*In C: SARS v Clicks Retailers (Pty) Ltd*<sup>41</sup> the taxpayer, who owns and operates a retail business nationwide, operated a loyalty programme under which it awarded points to members on presentation of a Clicks ClubCard at the checkout when making purchases from Clicks or one of its Affinity partners. The terms and conditions of the ClubCard contract regulated the relationship between Clicks and the customer under the loyalty programme. It did not cost anything to join the loyalty programme.

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<sup>40</sup> 2020 (6) SA 1 (CC), 82 SATC 403.

<sup>41</sup> 2020 (2) SA 72 (SCA), 82 SATC 167.

Customers in possession of a ClubCard were under no obligation to shop at Clicks or to present the ClubCard when making a purchase. At the end of each reward cycle, Clicks issued vouchers, R10 for every 100 points earned, to all ClubCard members who earned 100 or more points. The voucher could be redeemed when the ClubCard member makes a subsequent purchase from Clicks and presents their ClubCard and voucher. The voucher could not be redeemed for cash. Clicks claimed a section 24C allowance on the basis that it had an obligation to finance future expenditure when a voucher was redeemed at the time of a future sale and Clicks was required to supply the member with stock equal to the value of the voucher at no cost to the member. SARS disallowed Clicks' section 24C allowance on the basis that the first contract of purchase and sale which gave rise to income was a different contract to the loyalty programme's ClubCard contract which gave rise to the obligation to award points and vouchers. The court held that the right to income by Clicks was the first purchase and sale contract and the contract which obliges Clicks to honour vouchers was the ClubCard contract. Accordingly, the future expense sought to be deducted did not arise from the same contract as that under which the income arose and no allowance was available under section 24C.

In his concurring judgement Wallis JA held that there is a sound reason for the limitation in section 24C that the advance income and the obligation to perform must be in the same contract. He stated it as follows:<sup>42</sup>

“Most businesses recognise that they will be required in the ordinary course of their operations to incur future expenditure. An obvious example would be the need to make provision for the replacement of machinery and equipment in order to keep their operations up to date. In the case of businesses, such as the restaurants operated by Big G, sensible management would in any event, dictate that the external appearance of the restaurant and its interior décor be subject to refurbishment on a regular basis. This would occur irrespective of whether the business was being operated under a franchise agreement. The finance for such activities would have to be found from the ordinary stream of income of the business, or from borrowings. To permit an allowance for such future expenditure would result in future expenses being taken into account before they were incurred and afford taxpayers a means to manipulate the timing of tax payments. That was not the purpose of s 24C.

The reason s 24C was introduced was not to afford a means whereby the taxpayer could take account of expenses foreseen but not yet incurred, but to alleviate the tax burden that would otherwise rest on builders and other taxpayers engaged in manufacturing businesses, where it is the practice to obtain a deposit or other payment in advance of work being undertaken. This is neither here nor there if the deposit is received and the work done in the same tax year. The amounts received will be declared as income and the expenses incurred in performing the contract deducted as expenses incurred in the production of income. A problem arises where the deposit is paid in one year and the expenses in performing the contract are incurred in the following year. Absent s 24C the contractor would be obliged to declare and pay tax on the whole of the amount received in the first year and be left to set off against other income the expenses incurred in fulfilling the contract in the second year. In effect money paid to finance the performance of the contract would need to be diverted to the payment of tax, leaving the contractor to finance the performance of the contract from other resources. Permitting the taxpayer to deduct an allowance in respect of the cost of financing the performance of the contract in the second year restores the balance between income and expenditure.”

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<sup>42</sup> 2020 (2) SA 72 (SCA), 82 SATC 167 at 25 and 26.

In the Constitutional Court judgement in the *Clicks Retailers (Pty) Ltd v C SARS*,<sup>43</sup> Theron J held that, distilled to its essence, section 24C(2) has three requirements:<sup>44</sup>

“There must be (a) income earned by a taxpayer in terms of a contract (the income-producing contract); (b) an obligation on the taxpayer under a contract that requires future expenditure, which will be financed by this income (the obligation-imposing contract); and (c) contractual sameness. In the wake of *Big G*, this third requirement can be achieved either on a same contract basis (the income-producing contract and obligation-imposing contract are literally the same contract) or on a sameness basis (the income and obligation to finance expenditure are sourced in two or more contracts that are so inextricably linked that they meet the requirement of sameness). Clicks contends that it can claim a section 24C allowance on either a same-contract basis or a sameness basis.”

Theron J held that in Clicks’ submissions there is a notable lack of engagement with the meaning of “sameness” and why the loyalty programme contracts do or do not meet the requirement of sameness. The judge noted that the Constitutional Court in *C: SARS v Big G Restaurants (Pty) Ltd*<sup>45</sup> did not say that all that is required is for the income-generating and obligation-imposing contract to be inextricably linked, more is required and the taxpayer must show that the inextricable link between two contracts is such that the contracts meet the section 24C(2) “sameness” requirement. It was further held that South African law establishes an “inextricable link” when “an issue, claim, contract or conduct cannot be determined or assessed without another, or the legal consequence of the one cannot be understood or measured without reference to another”.<sup>46</sup> Theron J also stated as follows:<sup>47</sup>

“Thus, within the context of the loyalty programme, the two contracts are inextricably linked to the extent that firstly the obligations under the ClubCard contract are triggered by the sale contracts; and secondly Clicks’ obligation to finance expenditure when ClubCard points are redeemed is determined with reference to the amount of income earned in terms of one or more contracts of sale; and lastly there is a significant factual overlap and nexus between them. However, it must be determined whether the links between the two contracts give rise to a sameness between them.

Whatever the outer limits of the concept of sameness in this context may be, at a minimum both the earning of income and the obligation to finance future expenditure must depend on the existence of both contracts. If either contract can be entered into and exist without the other, they can hardly achieve sameness.

It is so that the accrual of income under a sale contract triggers and quantifies Clicks’ obligation to finance future expenditure but again, the actual obligation is sourced in the ClubCard contract and does not depend on the existence of a sale contract. Likewise, the sale contract does not owe its existence to the ClubCard contract. Income earned under the sale contract does not accrue to Clicks necessarily because it has undertaken an obligation to honour the redemption of loyalty points in the event that its ClubCard members earn points and become entitled to a discount. Clicks earns income through the sale of merchandise and not through entering into ClubCard contracts with its customers. Of course, the existence of a ClubCard contract may drive sales of Clicks merchandise, but income that accrues, in legal terms, is attributable to the relevant contract of sale. Clicks would earn the income regardless of whether there is a ClubCard contract in place.

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<sup>43</sup> 2021 (4) SA 390 (CC), 84 SATC 71.

<sup>44</sup> 2021 (4) SA 390 (CC), 84 SATC 71 at 31.

<sup>45</sup> SARS 2020 (6) SA 1 (CC), 82 SATC 403.

<sup>46</sup> 2021 (4) SA 390 (CC), 84 SATC 71 at 44.

<sup>47</sup> 2021 (4) SA 390 (CC), 84 SATC 71 at 45, 46, 47 and 48.



There are many respects in which the contracts function independently. Each contract of sale constitutes a complete contract on its own, with terms that are different to the Clubcard contract. In fact, the terms of each sale contract are the same regardless of whether the purchaser is a loyalty programme member and regardless of whether a Clubcard is presented.”

Theron J further held that the functional relationship of the two contracts (sale and loyalty programme contract) –<sup>48</sup>

“manifests in a number of factual and legal links between the two contracts, but these links do not render either contract dependent on the other for its existence, nor is their effect that income can only accrue to Clicks if both contracts are in place. The contract under which income accrues (the contract of sale) and the contract under which the obligation to finance future expenditure arises (the ClubCard contract) are simply too independent of each other to meet the requirement of contractual sameness. Whilst they may operate together within the context of the loyalty programme, and in that sense are inextricably linked or connected, this link is not sufficient to render the contracts the same for the purposes of section 24C. The contracts therefore fall short of the sameness that is required by section 24C.”

#### 4.2.2 Analysis on a contract-by-contract basis

The analysis required under section 24C must generally be performed on an individual contract-by-contract basis and an allowance will only be permitted if the income received or accrued under a contract will be used to wholly or partly finance the future expenditure which will be incurred as a result of performing under that same contract,<sup>49</sup> or under two or more contracts which are so inextricably linked that they satisfy the requirement of “sameness” under section 24C.<sup>50</sup>

##### **Example 2 – Contract-by-contract basis**

###### *Facts:*

In year 1 Company M concluded two contracts to build holiday homes.

Contract A – Company M received a payment equal to 60% of the contract price of R1 000 000, total costs are estimated to be R700 000, building had not yet commenced and no costs had been incurred.

Contract B – Company M received a payment equal to 50% of the contract price of R700 000, total costs were originally estimated to be R600 000, however, Company M now estimates that the total expenditure will be R750 000 because subsequent to signing the contract there was a significant increase in the cost of raw materials and Company M discovered a costing error in its estimation methodology.

<sup>48</sup> *Clicks Retailers (Pty) Ltd v C SARS* 2021 (4) SA 390 (CC), 84 SATC 71 at 89 and 90.

<sup>49</sup> ITC 1667 (1999) 61 SATC 439 (C); ITC 1697 (1999) 63 SATC 146 (N); ITC 1527 (1991) 54 SATC 227 (T); ITC 1890 (2016) 79 SATC 62(C); *C SARS v Big G Restaurants (Pty) Ltd* [2018] SA 90 (SCA), 81 SATC 185 and *C SARS v Clicks Retailers (Pty) Ltd* [2019] SA 72 (SCA), 82 SATC 167.

<sup>50</sup> *Big G Restaurants (Pty) Ltd v C: SARS* 2020 (6) SA 1 (CC), 82 SATC 403 and *Clicks Retailers (Pty) Ltd v C: SARS* 2021 (4) SA 390 (CC), 84 SATC 71.

*Result:*

Company M must consider the two contracts separately when calculating the section 24C allowance.

$$\begin{aligned}\text{Contract A's section 24C allowance} &= (\text{R}700\,000 / \text{R}1\,000\,000)^* \times \text{R}600\,000 \\ &= \text{R}420\,000\end{aligned}$$

$$\begin{aligned}\text{Contract B's section 24C allowance} &= (\text{R}750\,000 / \text{R}700\,000)^* \times \text{R}350\,000 \\ &= \text{R}350\,000\end{aligned}$$

\* Limited to 1 (see **5.2**).

Section 24C considers how much of the advance income will be used to wholly or partly finance the future expenditure that will be incurred in meeting the taxpayer's performance obligations under that contract. Accordingly, the amount of the allowance can never exceed the amount of income and the cost percentage is therefore limited to 100%.

In some situations it may be very difficult to analyse the future expenditure and link it to a particular contract under which advance income is received or accrued. There is an obligation to perform under the particular contract under which the advance income is received or accrued and in doing so incur expenditure, however, there may be practical difficulties associated with being able to analyse the expenditure in sufficient detail to be able to link it to a particular contract. In these situations, if the contracts are similar and the taxpayer has the same obligations to perform under those contracts then, when calculating future expenditure, the contracts may be grouped together and the taxpayer may combine the advance income and expenditure.

In contrast, in a contract to construct a building it is often practical, meaningful, realistic and necessary to analyse the contracts on an individual contract-by-contract basis and if, for example, a particular machine will be purchased and used on more than one contract, to allocate the cost of that machine to the various contracts based on the estimated hours of use, if appropriate. The machine in this example is one which is required for particular contracts and is not the replacement of an asset generally used in the business. This treatment appropriately takes account of the fact that building contracts are often not similar and have different obligations, revenue and cost profiles. It is critical that, even when contracts are grouped, each contract must contain unconditional obligations for the taxpayer to perform and that in performing those obligations the taxpayer will incur future expenditure.

The principle being raised is that in determining the amount of future expenditure and the amount which will be funded by the advance income, it may be appropriate to perform the analysis at a higher level by taking a number of contracts into consideration. The grouping of contracts for calculation purposes does not override the requirement of each contract to meet the requirements of section 24C by itself, for example, for the income and obligation to perform to be under the same contract. It is not possible to be prescriptive on the exact circumstances in which it will and will not be acceptable to take this approach – taxpayers will need to consider the particular facts and circumstances. Typically, the appropriate circumstances arise when the business enters into multiple contracts on an almost daily basis that are similar in scope and nature with the same or similar performance obligations, revenue profiles and cost profiles.

For example, it may be appropriate to group the following contracts together:

- Advance subscriptions for a particular magazine.
- A transport business that sells bus tickets or air tickets in advance.

In these circumstances, it may be reasonable to use the taxpayer's overall gross profit percentage to calculate the section 24C allowance for contracts which have been grouped together. However, the particular contract must be considered because it may be appropriate and necessary to apply a more specific gross profit percentage, for example, the gross profit percentage of a particular department. The gross profit percentage calculation would also have to be reviewed to assess whether any costs or income must be excluded. For example, depreciation (represents past expenditure), financing costs (often not included in gross profit but the particular calculation needs to be considered), costs not related to performing obligations under the contract and items which have already been purchased and will be drawn from trading stock on hand at the end of the year of assessment, would need to be excluded (in this regard, if the future expenditure relates to trading stock, stock turnover ratios are relevant). In addition, known or anticipated price increases and decreases should be taken into account.

### **Example 3 – Gift Vouchers**

*Facts:*

Company Z sells gift vouchers which may only be redeemed for goods in the homeware department. Company Z's financial statements reflect a gross profit percentage, which takes into account depreciation on store fittings and assets, for the company of 45%. The financial statements also reflect advance income for gift vouchers sold but not redeemed by year-end. The management accounts reflect a gross profit percentage of 40% for the homeware department.

*Result:*

Company Z will be entitled to a section 24C allowance on the advance gift voucher income. The gross profit percentage for the homeware department may be a good starting point for purposes of estimating future expenditure; however, Company Z will have to review the gross profit percentage calculation to assess whether any costs or income must be excluded (see **4.2.2** for examples of the type of adjustments which may be required). It will also be necessary to review the age of the gift vouchers because even if the gift vouchers never expire, at some point in time unredeemed vouchers are unlikely to be redeemed (for example, lost by the customer) and will not lead to future expenditure.

**Note:**

- 1) In the Example the advance gift voucher income was received by the taxpayer and included in income which is one of the requirements under section 24C.

- 2) In ITC 1918<sup>51</sup> the taxpayer was a retailer that “sold” gift cards to its customers that could be redeemed at any of its stores. Although colloquially referred to as a “sale”, the court found that the “sale” was actually a prepayment and the physical gift card merely vouched for the existence of a personal right against the taxpayer for redemption of the prepayment. The Court found that prior to considering the impact of the Consumer Protection Act 68 of 2008 (the CPA), there was no applicable trust relationship and the amounts would have been received by the taxpayer for purposes of gross income. However, the Court found that the taxpayer was a supplier as defined in the CPA and that the “sale” was regulated by section 63 and section 65 of that Act. Section 63 provides that the consideration received is the property of the bearer of the gift card to the extent it has not been redeemed in exchange for goods or services. Section 65 provides that the supplier must not treat the consideration as the supplier’s own and “in the handling, safeguarding and utilisation of that property, must exercise the degree of care, diligence and skill that can reasonably be expected of a person responsible for managing any property belonging to another person”. The Court held that the CPA and the taxpayer’s adherence to its requirements resulted in some form of statutory trust in which the cardholder is given a proprietary interest and the taxpayer has a fiduciary duty to the bearer. Otherwise stated, after applying and complying with the CPA, the taxpayer did not receive the money from the “sale” of gift cards on its own behalf for its own benefit and it should not be included in gross income. Binns Ward J stated the following:<sup>52</sup> “... *if the manner in which the CPA protects consumers entails the deferral of beneficial receipt of revenue by suppliers as a matter of fact, then the knock-on effect on the determination of the suppliers’ taxable income is only to be expected.*”
- 3) ITC 1918 is relevant because it highlights that if the provisions of the CPA apply and are fully complied with, the outcome otherwise achieved in applying the general principles applicable to the definition of gross income may be different (in Example 3 the advance gift voucher income was included in gross income under general principles). If the CPA applied and the provisions were fully complied with such that the advance gift voucher income was not included in gross income then there would have been no income received or accrued in advance and an allowance under section 24C would not have been available. The specific facts and circumstances of each case, the relevant provisions of the CPA and the taxpayer’s compliance with the requirements of the CPA must be considered in determining whether an amount should be included in gross income.

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<sup>51</sup> (2019) 81 SATC 267 (C).

<sup>52</sup> (2019) 81 SATC 267 (C) in 42.

**Example 4 – Calculation of section 24C allowance on future service to be rendered (multiple contracts)**

*Facts:*

Company J provides long distance passenger transport to and from the major cities in South Africa. Demand for its service is at a peak because of its impressive safety record. Passengers must pay the full price of the fare before being issued with a ticket.

During the first year of assessment (year 1) Company J received R300 000 in advance for services to be rendered in the second year of assessment (year 2). Company J has a December year-end.

The table provides an analysis of the advance receipts and the taxpayer's obligation:

<b>Destination (trip)</b>	<b>No of tickets sold</b>	<b>Price per ticket</b> R	<b>Amount received in advance</b> R
Johannesburg to Durban	282	450	126 900
Cape Town to Johannesburg	141	700	98 700
Cape Town to Durban	<u>120</u>	620	<u>74 400</u>
Total	<u>543</u>		<u>300 000</u>

Company J estimated that its operating costs will not increase or decrease in year 2. An extract from Company J's year 1 financial records revealed the following about the company's income and expenses:

	R	R
<b>Income</b>		
Services rendered/ticket sales		13 250 000
<b>Expenses</b>		
Advertising and promotion	128 000	
Auditor's remuneration	15 000	
Depreciation – buses	2 400 000	
Depreciation – office equipment	46 000	
Electricity	7 430	
Fuel	2 554 000	
Rent of premises – office and bus depot	600 000	
Repairs and maintenance - buses	1 453 000	
Salaries – admin	980 000	
Salaries – drivers	1 489 000	
Security – rented building	49 000	
Telephone	47 000	
Tracking and monitoring services	920 000	
Website – maintenance	724 000	
Insurance	485 000	
Total expenditure		<u>(11 897 430)</u>
<b>Net Profit</b>		<u>1 352 570</u>

*Result:*

**Step 1:** Estimate the total amount of expenditure which will be incurred in year 2 in order to meet the obligations relating to the pre-sold tickets.

Company J reviewed the information in its financial records for year 1 and estimated the total direct costs associated with transporting clients to the various destinations to be as follows:

<b>Expense item</b>	<b>Estimated Total Future Expenditure R</b>
Fuel	2 554 000
Salaries – drivers	1 489 000
Tracking and monitoring services	920 000
Insurance (see note 3)	<u>242 500</u>
Total estimated costs	<u>5 205 500</u>

**Notes:**

- 1) Company J did not include any depreciation because it represents past expenditure and Company J does not anticipate purchasing any new vehicles in the next 18 months.
- 2) The repairs and maintenance expense relates primarily to the costs incurred when vehicles break down. Although Company J knows from past experience that vehicles will break down, costs relating to repairing the vehicles have not been included in estimated future expenditure because as at the end of the year of assessment no break down has occurred and accordingly there is insufficient certainty regarding the expense. Company J considers the portion of the expense relating to the regular standard service which each bus undergoes to be immaterial and has not separately analysed it.
- 3) The cost of insuring the buses is expenditure that is directly linked to the provision of the future service. Company J insures other assets, for example, buildings, equipment and other vehicles, which are not directly related to the provision of the bus transportation services. The insurance premium is determined on the total value of the insured assets and is not broken down into a premium per asset type. The insured value of each category of asset is as follows:

	R
Buildings	3 000 000
Equipment	1 500 000
Buses	5 000 000
Other vehicles	<u>500 000</u>
Total insured value of assets	<u>10 000 000</u>

The insurance premium is apportioned based on the value of the insured assets to determine the portion of the premium that applies to the buses.

$$\begin{aligned}
 \text{Portion of insurance premium applicable to the buses} &= \frac{\text{insured value of buses}}{\text{insured value of total assets}} \times \text{annual insurance premium} \\
 &= \frac{\text{R5 000 000}}{\text{R10 000 000}} \times \text{R485 000} \\
 &= \text{R242 500}
 \end{aligned}$$

A taxpayer must be able to substantiate the basis of apportionment of expenditure as the *onus* is on the taxpayer to prove the future expenditure being claimed.

**Step 2:** Determine the total amount of income which will be received under the contract. This amount is equal to R13 250 000 – Company J has estimated that its income and expenses for year 2 will be the same as it was in the current year.

Note: Assume for the purposes of this example that this is a reasonable assumption, in practice Company J would need to be able to substantiate that this is a reasonable assumption and estimation.

**Step 3:** Determine the total amount of advance income received or accrued under the contract. This amount will be the R300 000 advance ticket sales.

**Step 4:** Determine what amount of future expenditure relates to the amount of income in the particular year of assessment by applying the following formula:

$$\begin{aligned} \text{Section 24C allowance} &= [(\text{Total costs} / \text{Total revenue})^* \times \text{Income received or} \\ &\quad \text{accrued to date}^{**}] - \text{Actual expenses incurred to date} \\ &\quad \text{relating to that income} \\ &= [(R5\,205\,500 / R13\,250\,000) \times R300\,000] - \text{nil} \\ &= R117\,860 \end{aligned}$$

\* Limited to 1 (see 5.2).

\*\* Excluding the reversal of prior year's section 24C allowances

**Step 5:** Limit the amount of the section 24C allowance calculated in terms of the formula to the amount of advance income received in the particular year of assessment. The amount of advance income is R300 000 and the amount of the section 24C allowance is R117 860. The full amount of the allowance calculated therefore qualifies. The taxpayer's section 24C allowance in year 1 is thus R117 860. The section 24C allowance in year 1 of R117 860 will be included in the taxpayer's income in year 2.

#### 4.2.3 Expenditure is incurred in such a manner that the expenditure will be allowed as a deduction in a subsequent year

Under this criteria, the expenditure, when incurred, must be deductible expenditure for purposes of the Act in order to qualify as an allowance under section 24C. In *Sub-Nigel Ltd v CIR*<sup>53</sup> the Supreme Court of Appeal confirmed the principle that in considering the deductions to which a taxpayer is entitled, one should have regard to the wording of the Act and not the treatment of the deduction for accounting purposes. The court held as follows:<sup>54</sup>

“At the outset it must be pointed out that the Court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the Act. See *Joffe & Co., Ltd. v Commissioner for Inland Revenue* (1946, A.D. 157 at p. 165).”

<sup>53</sup> 1948 (4) SA 580(A), 15 SATC 381.

<sup>54</sup> At SATC 389.

In evaluating whether a taxpayer will be entitled to a deduction, consideration must be given to the deductions allowable under section 11 and more particularly section 11(a) which contains the general deduction formula. However, section 24C is not prescriptive on the section under which the deduction must be granted and is not limited to section 11.

In addition to considering sections which may permit a deduction, it is important to consider section 23 which deals with the circumstances in which a deduction will not be allowed in spite of meeting the requirements for a deduction under another section. Section 23(g) is particularly relevant although all the provisions of section 23 must be considered. The facts and circumstances of each case must be considered in assessing if a taxpayer will be entitled to claim a deduction under a specific provision of the Act.

#### 4.2.4 Expenditure on the acquisition of an asset

Under this criteria, the future expenditure<sup>55</sup> must relate to expenditure which will be incurred on the acquisition of an asset for which any deduction will be admissible under the Act. Applicable assets include assets which will be acquired in order to perform under the specific contract giving rise to the advance income. The acquisition of assets generally used in the taxpayer's trade will not qualify for an allowance under section 24C.

This type of future expenditure relates to the expenditure which will be incurred in acquiring an asset. It does not relate to the deduction of, for example, a capital allowance on an asset which has already been acquired and the expenditure already incurred. A similar issue arises with trading stock when a taxpayer has incurred expenditure in acquiring items of trading stock. Once the expenditure has been incurred it does not constitute future expenditure even if the trading stock is included in the taxpayer's closing stock.

*Juta Law* explains the position as follows:<sup>56</sup>

“Where the advance payment received or accrued is utilised to purchase a capital asset which is subject to wear and tear (in terms of s 11(e) or s 12C, as to which see notes) or other allowances in terms of the Act, no allowance under the section can be available once the asset concerned has been purchased, since there is no longer any relevant future expenditure. The cost of the asset should therefore be allowed in the year in which the advance payment is received, and in any subsequent years until the asset is purchased. Once this takes place, however, no further allowances should be granted. Meyerowitz (at 12.83) suggests a different approach, in terms of which the cost of the asset, as reduced by the wear and tear or other allowances claimed on that asset, is granted as an allowance throughout the relevant period. This allowance therefore declines year by year as it is reduced by the cumulative allowances claimed on that asset. This approach is not supported by the wording of the provision.”

The position is correctly stated by *Juta Law* as the wear-and-tear on capital assets does not qualify as “future expenditure” as defined in section 24C(1).

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<sup>55</sup> Section 24C(1)(b).

<sup>56</sup> D Davids *et al Juta's Tax Library* [online] (Jutastat e-publications:) in commentary on Income Tax-section 24C: Allowance in respect of future expenditure on contracts.



**Example 5 – Acquisition of an asset***Facts:*

In the first year of assessment (year 1) a taxpayer, Company G, entered into a two-year contract with the local municipality for the construction of a road. The contract price was R1 000 000. The municipality paid Company G R500 000 in year 1, R300 000 in the second year of assessment (year 2) and R200 000 in the third year of assessment (year 3).

Company G did not incur any expenditure in year 1.

On the first day of year 2 Company G purchased a truck, which was only used in the construction of this road, for R150 000. SARS allowed the truck to be written off under section 11(e) over a period of three years.

*Result:*

<b>Year 1</b>	R
Gross income	500 000
Less: Cost of the truck to be purchased [section 24C(2)]	(150 000)
<b>Year 2</b>	
Gross income	300 000
Section 24C allowance allowed in year 1	150 000
Section 24C allowance*	Nil
Less: Wear-and-tear allowance [33,3% × R150 000, section 11(e)]	(50 000)
<b>Year 3</b>	
Gross income	200 000
Section 24C allowance*	Nil
Less: Wear-and-tear allowance [33,3% × R150 000, section 11(e)]	(50 000)

\* A section 24C allowance was not allowed in year 2 or year 3 as the truck was purchased at the beginning of year 2 and its cost is therefore actual expenditure and not future expenditure at the end of those years of assessment.

**4.2.5 Application of section 24C to ceded contracts**

In certain situations a taxpayer may cede a contract under which the taxpayer has received advance income and has previously claimed an allowance under section 24C. An example of this situation arises when the contract is sold as part of the sale of an enterprise as a going concern.

Under these circumstances [that is, the cessionary (transferee or purchaser) has taken over the cedent's (transferor's or seller's) obligation for future delivery under the contract]:<sup>57</sup>

- The cedent is no longer responsible for any performance under the contract and will not incur any future expenditure. Accordingly, the cedent will have to include the prior year's section 24C allowance for that contract in

<sup>57</sup> Assuming the provisions of the corporate rules in sections 41 to 47 are not applicable.

income<sup>58</sup> and will not be able to claim another section 24C allowance. The cedent will therefore be taxed on the advance income received.

- The cessionary will be entitled to a section 24C allowance for any advance income the cessionary receives, provided the detailed requirements of section 24C are met. The cessionary will not qualify for a section 24C allowance in relation to any advance income which the cedent received.

The above is applicable if the cession is effective. If the cession is not yet effective at the end of the year of assessment,<sup>59</sup> although the seller is still responsible for performance under the contract, the likelihood of the sale becoming effective and the obligation to perform passing to the purchaser must be taken into account in estimating the quantum of future expenditure that the taxpayer will incur. The amount of future expenditure will be *nil* in the seller's hands at the end of the year of assessment if all the conditions have been met and it is merely a matter of time passing until the agreement is effective on the first day of the new year of assessment.

#### 4.2.6 Application of section 24C to warranty claims

Contracts under which advance income is received may contain a warranty against defective workmanship or materials supplied.

*Dictionary.com* defines the word "warranty" as follows:<sup>60</sup>

"3 a written guarantee given to the purchaser of a new appliance, automobile, or other item by the manufacturer or dealer, usually specifying that the manufacturer will make any repairs or replace defective parts free of charge for a stated period of time."

In the event that the workmanship or material supplied is defective and the asset, for example, malfunctions, the taxpayer will be required to correct the deficiency and in so doing will often incur expenditure.

A warranty may be included as part of a contract, for example, the sale of an electrical appliance which has a 12-month warranty. Alternatively, a warranty may be the subject of a separate contract which gives rise to its own income; for example, the sale of an electrical appliance may include a 12-month warranty but customers may also have the option of purchasing an extended warranty which increases the warranty to 24 months. The principles considered in **4.2.1(b)** are applicable to both of these types of warranties.

The court considered whether warranty claims may be deducted under section 24C in ITC 1601.<sup>61</sup> The salient facts of the case were that the taxpayer concerned sold computers and measuring instruments. The taxpayer also provided the services of programming and setting up the hardware and instruments to the clients' requirements. The contracts with the clients contained a warranty against defective workmanship and materials supplied. In addition, all manufactured goods contained a manufacturer's warranty. A warranty claim arose on almost all contracts because of the technical nature of the work. The taxpayer's claim for an allowance for future expenditure was disallowed by the Commissioner. The court held that in considering the facts before him, the Commissioner was entitled to come to the conclusion that he was not satisfied

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<sup>58</sup> Section 24C(3).

<sup>59</sup> For example, the sale of a going concern, if the transfer will or may only take place in the subsequent year of assessment.

<sup>60</sup> <https://www.dictionary.com/browse/warranty> [Accessed on 21 July 2023].

<sup>61</sup> (1995) 58 SATC 172 (C).

that future expenditure would be incurred. The court also held that on the facts of the particular case the Commissioner was entitled to come to the conclusion that he could not be satisfied that future expenditure will be incurred when a contingent liability is recoverable or partly recoverable under a guarantee.

In ITC 1739<sup>62</sup> the taxpayer manufactured certain components which were supplied to original equipment manufacturers that in turn manufactured and supplied vehicles to distributors and dealers. The vehicles were sold subject to a warranty. In the event of a warranty claim the taxpayer would supply the parts required and the distributor or dealer would perform the necessary repairs. The court held that the taxpayer was not entitled to claim an allowance for future parts that it may have to supply under the warranty obligation. The cost of the parts did not constitute future expenditure, it constituted losses incurred on supplying trading stock as replacement for the defective parts. The court explained the position as follows:<sup>63</sup>

“In terms of the section the Commissioner must be satisfied that the income or revenue will be used in whole or in part to finance future *expenditure* (as distinct from losses) which will be incurred by the taxpayer in the performance of his obligations under the contract before the allowance will be deducted. See *ITC 1527 54 SATC 227 on 236*.

Regard being had to the facts alluded to above in the present matter the appellant meets warranty claims made on it. In doing so it incurs losses in supplying parts from its trading stock in replacement of defective parts. For an allowance to be granted in terms of s 24C income must be received or accrued in the current year of assessment, which will be used to finance *future expenditure*.”

In the event of a warranty claim the facts of a particular case will determine whether the taxpayer –

- will use assets already purchased and on hand at the end of the year of assessment and will thus not incur future expenditure; or
- would have to acquire the replacement asset and would thus incur future expenditure.

A section 24C allowance is not available in either situation because the event which potentially gives rise to the warranty claim (for example, the equipment malfunctioning because of a defect in labour or materials) is contingent and is not only dependent on the customer returning the item.<sup>64</sup> The asset purchased by the taxpayer’s customer may or may not malfunction which means that there is insufficient certainty that the related warranty expenditure will be incurred in the future.

#### **4.2.7 Application of section 24C to maintenance contracts**

It is not possible to formulate a general rule for the treatment of maintenance obligations under section 24C. The availability of a section 24C allowance will depend on whether the taxpayer’s obligations to perform are contingent on something other than just the client making the asset available for maintenance. In the result it must be established by the taxpayer whether there is sufficient certainty that expenditure will be incurred in the future. Each case must be determined on its own facts and circumstances.

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<sup>62</sup> (2002) 65 SATC 43 (G).

<sup>63</sup> At SATC 46.

<sup>64</sup> In addition, there is no future expenditure if a taxpayer uses assets already purchased and on hand.

For example, some contracts contain provisions for after-sales maintenance under which the maintenance will only be required if something breaks or malfunctions. In these circumstances it is uncertain if the expenditure will be incurred in the future.

There are, however, circumstances in which there will be sufficient certainty that the expenditure will be incurred in the future, for example, in the case of a motor vehicle service plan under which certain maintenance must be performed at regular intervals (assuming the client makes its motor vehicle available for the service to take place). Such maintenance expenditure may qualify for a deduction under section 24C provided the other requirements of the section are met.

The taxpayer bears the *onus* of proving that the expenditure will be incurred in the future.<sup>65</sup>

### **Example 6 – Maintenance contracts**

#### *Facts:*

Individual X runs a car service business from home. Business was slow and, in an attempt, to increase revenue X sold “Car health check and maintenance packages”. The price was payable upfront and the package was valid for a period of six months after purchase. At the end of the year of assessment X had sold 10 packages which had not yet been used and had not expired.

Under the package, X will –

- i) replace the oil;
- ii) check and, if necessary, replace the brake pads, and
- iii) wash the car.

X was able to reliably estimate the costs which will be incurred based on experience of the time the different tasks will take and the latest prices (which are not expected to change) for the labour and materials.

#### *Result:*

In order to perform under the contract and to provide the service as agreed, X’s employees must replace the oil, check the brake pads and wash the car. X will incur expenditure for the oil, shampoo and water which will be used and accordingly these amounts will constitute future expenditure.

Although X will have to check the brake pads, X does not know whether the brake pads will need to be replaced as that will depend on the condition of the particular car’s brake pads. Accordingly, despite the fact that X has included the cost of replacement brake pads into the budget and that experience and statistical data indicate that X will need to replace the brake pads on some cars, there is insufficient certainty that X will incur future expenditure in relation to the possible replacement cost of brake pads.

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<sup>65</sup> Section 102 of the TA Act.

## 5. Determination of the amount of the section 24C allowance

The amount of the section 24C allowance is –

- the amount of future expenditure which relates to the amount of advance income; and
- which does not exceed the amount of such income received or accrued in the particular year of assessment.

### 5.1 The amount of future expenditure which relates to the amount of advance income

The principles considered in 4.2 are relevant in determining what amounts constitute future expenditure.

A section 24C allowance is not available for the portion of advance income which effectively represents the taxpayer's profit or which was used<sup>66</sup> to fund expenditure that has already been incurred in respect of the contract. Advance income cannot be used to fund future expenditure if it funds profit or expenses already incurred.

Stated differently, taxpayers need to determine and be able to substantiate how much of the future expenditure relates to the advance income which was received or accrued under the relevant contract. For example, assume a taxpayer receives 50% of the contract price in year one and does not incur any expenditure. Although all the costs the taxpayer will incur in the future in performing under the contract are future expenditure, all the costs do not constitute future expenditure which relates to the amount of the advance income. The advance income represents an element of profit and an element of future expenditure. SARS agrees with the suggestion in *Silke*<sup>67</sup> that it is the intention of the recipient and not the payer which is relevant in this regard.

The amount of future expenditure which relates to the advance income will depend on the facts and circumstances of the particular case. The Act does not prescribe the methods which must be used to make this determination. An allocation based on the gross cost percentage will, however, be appropriate in a number of cases.

If the 'gross cost' method is appropriate, taxpayers will need to –

- estimate the total amount of expenditure which will be incurred in order to meet the obligations under the contract, remembering that certainty that the expenditure will be incurred in the subsequent year of assessment is a critical factor;
- determine the total amount of income which will be received by or accrued to the taxpayer under the contract;<sup>68</sup>
- determine the total amount of income received by or accrued under the contract to date;<sup>69</sup>
- determine what amount of that future expenditure relates to the amount of income received or accrued to date by applying the formula listed below; and

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<sup>66</sup> Or "will use" if the taxpayer has incurred an unconditional liability but must still settle that liability.

<sup>67</sup> AP de Koker and RC Williams *Silke on South African Income Tax* [online] (My LexisNexis November 2022) in § 8.60.

<sup>68</sup> This does not include the reversal of prior year's section 24C allowances.

<sup>69</sup> This does not include the reversal of prior year's section 24C allowances.

Section 24C allowance = [(Total costs / Total revenue)\* × Income received or accrued to date<sup>70</sup>] – Actual expenses incurred to date relating to that income

\* Limited to 1 (a section 24C allowance is granted on an amount received by or accrued to a taxpayer that will be used to finance future expenditure, accordingly the maximum possible allowance before deducting actual expenses incurred to date or applying the limitation in the point below, is the amount of the income received or accrued to date.<sup>71</sup> This means Total costs / Total revenue is limited to 1).

- limit the amount of the section 24C allowance calculated in terms of the formula above to the amount of income received or accrued under the contract in the particular year of assessment (see 4.1 for income, see 5.2 for more detail on the calculation of the limit).

The gross cost method may not be appropriate in all cases, for example, if the advance income relates solely to a particular stage of a project or to specific items of expenditure, as agreed between the taxpayer and the client.

Taxpayers must base their determinations of the amount of future expenditure on fair and reasonable estimates which take into account the latest available information. The level of detail required to support the determination will depend on the specific facts and circumstances. However, as a general guideline, the estimates and calculations must contain sufficient detail to demonstrate –

- that the future expenditure included in the calculation results from the future performance of obligations under the contract;
- that the expenditure only includes permissible expenditure (for example, excludes wear-and-tear allowances and items taken from assets previously acquired); and
- that allows the items taken into account to be reviewed, audited and substantiated with supporting evidence, if required.

The taxpayer's obligations under the contract must be apparent or determinable [see 4.2.1 (c)] and it is only future expenditure incurred in performing these obligations which will be permitted under the section 24C allowance (subject to the limitations considered in this Note). If the future expenditure is not incurred in performing an obligation under the contract (for example, it is something performed voluntarily) or the advance income is not utilised to finance the future expenditure, then no section 24C allowance is available. It is therefore important that the estimate and calculation contain sufficient detail regarding the different types and items of expenditure that will be incurred and that the taxpayer is able to demonstrate that the expenditure included relates to the future performance of the apparent or determinable obligations under the contract which will be funded by the advance income under that contract.

<sup>70</sup> Excluding the reversal of prior year's section 24C allowances.

<sup>71</sup> Section 24C(2).

Section 24C does not require the taxpayer to deposit the funds received in advance into a separate bank account and to only use the funds from that account to settle the expenditure incurred in order to meet the requirement and be able to prove that the advance income will be used to finance future expenditure.

### Example 7 – Construction contract

*Facts:*

A contractor entered into an agreement with a client. The details of their agreement are as follows:

- The agreement was entered into in the first year of assessment (year 1).
- The contractor undertook to build office buildings for the client.
- The contract price is R1 000 000.

The client paid the contractor R500 000 in advance in year 1 and the balance of the contract price in the third year of assessment (year 3). The contractor's year of assessment ends on the last day of February each year. In years 1 and 2 the contractor estimated that total expenditure would be R400 000.

The contractor actually incurred expenditure of R30 000 during year 1, R130 000 during year 2 and R450 000 during year 3. The total actual expenditure of R610 000 exceeded the contractors initial estimate because of unexpected price increases in year 3.

*Result:*

#### Year 1

$$\begin{aligned} \text{Section 24C allowance} &= [(\text{Total costs} / \text{Total revenue})^* \times \text{Income received or} \\ &\quad \text{accrued to date}^{**}] - \text{Actual expenses incurred to date} \\ &\quad \text{relating to that income} \\ &= [(R400\,000 / R1\,000\,000) \times R500\,000] - R30\,000 \\ &= R170\,000 \end{aligned}$$

	R	R
Gross income		500 000
<i>Less:</i>		
Actual expenses	30 000	
Section 24C(2) allowance	170 000	<u>(200 000)</u>
Taxable income		<u>300 000</u>

#### Year 2

$$\begin{aligned} \text{Section 24C allowance} &= [(\text{Total costs} / \text{Total revenue})^* \times \text{Income received or} \\ &\quad \text{accrued to date}^{**}] - \text{Actual expenses incurred to date} \\ &\quad \text{relating to that income} \\ &= [(R400\,000 / R1\,000\,000) \times R500\,000] - R160\,000 \\ &= R40\,000 \end{aligned}$$

	R	R
Gross income		Nil
Section 24C allowance allowed in year one		<u>170 000</u>
		170 000
<i>Less:</i>		
Actual expenses	130 000	
Section 24C(2)	40 000	<u>(170 000)</u>
Taxable income		<u>Nil</u>
* Limited to 1		
** Excluding the reversal of prior year's section 24C allowance		
<b>Year 3</b>		
Gross income		500 000
Section 24C allowance allowed in year 2		<u>40 000</u>
		540 000
<i>Less: Actual expenditure</i>		<u>(450 000)</u>
Taxable income		<u>90 000</u>
Under section 22(2A) and 22(3A) trading stock deemed to be held and not disposed is nil for each of the relevant years.		

### **Example 8 – Construction contracts**

#### *Facts:*

During the year Company Y entered into a construction contract which is expected to be completed in 25 months.

The total contract price is R275 000. Invoices may only be raised by Company Y on work that has been certified by the client. A retention of 10% is applicable to all billings. Company Y initially estimated total expenditure would be R225 000.

Company Y received payments totalling R110 000 during the year (R100 000 payment of the contract price and R10 000 *ad hoc* quality bonus awarded by the client). The client awarded the *ad hoc* quality bonus in year 1 to incentivise Company Y and encourage consistency in quality throughout the construction process.

At the end of the year work certified totalled R120 000 and expenditure incurred totalled R100 000. Company Y reviewed the project and estimated that the remaining expenditure to complete the project would be R200 000. That is, the estimated total expenditure had increased to R300 000 (R100 000 actual and R200 000 future expenditure).



<i>Result:</i>	
	R
Gross income – Construction (see working 1)	108 000
Gross income - Quality bonus	10 000
Less: Deductible expenditure [section 11(a)]	<u>(100 000)</u>
	18 000
Less: Section 24 allowance (see working 2)	<u>(8 000)</u>
<b>Taxable income</b>	<u>10 000</u>
Under section 22(2A) and 22(3A) trading stock deemed to be held and not disposed is nil.	
<b>1) Working 1 – gross income (greater of receipt or accrual)</b>	
<i>Accrued</i>	
	R
Work certified	120 000
Less: retention (10%)	<u>(12 000)</u>
	<u>108 000</u>
<i>Received</i>	
Cash received	110 000
Quality bonus	<u>(10 000)</u>
	<u>100 000</u>
Therefore, gross income (greater of receipt and accrual)	108 000
<b>2) Working 2 – section 24 C allowance</b>	
Section 24C allowance (minimum is Rnil) = [(Total costs / Total revenue)* x Income received or accrued to date**] – Actual expenses incurred to date relating to that income	
	R
Total costs = Costs to date + costs to complete	300 000
Total revenue	275 000
Total income received or accrued to date (working 1)	108 000
Actual expenses incurred to date relating to that income	100 000
Section 24C allowance = [(R300 000 / R275 000)* x R108 000] – R100 000	
	= R8 000
* = limited to 1 (see 5.2)	
** Excluding the reversal of prior year's section 24C allowance (if applicable)	
The section 24C allowance is less than the income accrued or received in the current year, therefore there is no need to further limit the allowance, see 5.2.	

## 5.2 Which does not exceed the amount of such income received or accrued in the particular year of assessment

The amount of the section 24C allowance is limited to the amount of income received or accrued under the contract in a particular year of assessment<sup>72</sup> and not to the taxpayer's taxable income before determining and deducting a section 24C allowance.

The limiting factor is the amount of income received or accrued under the contract in a particular year of assessment (see 4.1) and not the taxpayer's taxable income before the allowance being granted.<sup>73</sup>

### Example 9 – Limitation of the amount of the section 24C allowance

*Facts:*

Company D, a prominent builder, is incurring a loss on one of its building contracts. The contract was supposed to be completed in year 1 but it is estimated that it will only be completed in year 2. The contract was concluded at a sales price of R5 000 000 (which the client paid in advance), actual costs to date are R4 000 000 and expected future costs are R1 200 000.

*Result:*

$$\begin{aligned}
 \text{Section 24C allowance} &= [(\text{Total costs} / \text{Total revenue})^* \times \text{Income received or} \\
 &\quad \text{accrued to date}] - \text{Actual expenses incurred to date} \\
 &\quad \text{relating to that income} \\
 &= [(R5\ 200\ 000 / R5\ 000\ 000)^* \times R5\ 000\ 000] - R4\ 000\ 000 \\
 &= R1\ 000\ 000
 \end{aligned}$$

The amount of the section 24C allowance available in year 1 is equal to R1 000 000.

\* = limited to 1

### Example 10 – Limitation of the amount of the section 24C allowance

*Facts:*

In year 1 Company N concluded and completed a contract with a sales price of R2 000 000 for the supply of goods which it had budgeted would cost R1 500 000. Unfortunately, for reasons beyond its control, the goods supplied during the year actually cost Company N R2 500 000.

Company N also concluded a second contract with a sales price of R1 000 000 and received the full price in cash before the end of the year. No expenditure was incurred during the year. Estimated future expenditure is R600 000.

<sup>72</sup> This is both implicit and expressly stated in section 24C(2).

<sup>73</sup> See ITC 1697 (1999) 63 SATC 146 at 154 – 155 which confirms this interpretation.

<i>Result:</i>	<b>Contract 1</b>	<b>Contract 2</b>	<b>Total</b>
	<b>R</b>	<b>R</b>	<b>R</b>
Gross income	2 000 000	1 000 000	3 000 000
Section 11(a) expenditure	(2 500 000)	Nil	(2 500 000)
Section 24C allowance*	<u>Nil</u>	<u>(600 000)</u>	<u>(600 000)</u>
Assessed loss	<u>(500 000)</u>	<u>400 000</u>	<u>(100 000)</u>

\* Contract 1 – the contract was completed before the end of the year of assessment and there is no future expenditure. Section 24C is not applicable.

Contract 2 – Section 24C allowance = [(Total costs / Total revenue)\*\* × Income received or accrued to date] – Actual expenses incurred to date relating to that income

= [(R600 000 / R1 000 000)\*\* × R1 000 000] – R0

= R600 000

\*\* = limited to 1

### **Example 11 – Limitation of the amount of the section 24C allowance**

#### *Facts:*

Company G concluded a construction contract in year 1. The full contract price of R1 000 000 was received during year 1, but no building had commenced by the end of the year of assessment. Company G estimated the future expenditure would be R500 000 and claimed a section 24C allowance of R500 000 in year 1.

In year 2 Company G experienced a number of delays but commenced building just before the end of the year of assessment and incurred R60 000 in expenditure. Company G, taking into account current information, estimated that the costs to complete the project would be R600 000. That is, Company G's estimate of total expenditure increased from R500 000 to R660 000 (R60 000 actual expenditure and R600 000 future expenditure).

#### *Result:*

<b>Year 1</b>	<b>R</b>
Gross income	1 000 000
Less: Section 24C allowance	<u>(500 000)</u>
Taxable income	<u>500 000</u>
<b>Year 2</b>	
Gross income	Nil
Section 24C – reversal	500 000
Less: Section 11(a)	(60 000)
Less: Section 24 allowance – refer to workings (1 & 2)	<u>(500 000)</u>
	<u>(60 000)</u>

Under section 22(2A) and 22(3A) trading stock deemed to be held and not disposed is nil for each of the relevant years.

*Workings:*

1. Working 1 – Section 24C allowance = [(Total costs / Total revenue)\* × Income received or accrued to date] – Actual expenses incurred to date relating to that income

$$= [(R660\ 000 / R1\ 000\ 000)^* \times R1\ 000\ 000] - R60\ 000$$

$$= R600\ 000.$$

2. Working 2 – Section 24C allowance per working 1 (R600 000) but limited to income received in the particular year of assessment which in year 2 is the prior year's reversal of R500 000. Therefore, the section 24C allowance in year 2 is R500 000.

\* limited to 1

## 6. Reversal of the prior year's section 24C allowance

Section 24C(3) stipulates that an allowance deducted in any year of assessment is deemed to be income received or accrued to the taxpayer in the succeeding year of assessment. This provision is not discretionary; if a taxpayer claims a section 24C allowance in a year of assessment such allowance must be reversed and included in the taxpayer's income in the following year of assessment.

Generally, the claiming of the allowance in one year (assuming all the requirements of section 24C were met) and the reversal in the next year is in the same taxpayer's calculation of taxable income for the respective years of assessment. However, if the corporate rules in sections 41 to 47 apply to transactions that have taken place, the reversal of the allowance claimed in the previous year of assessment may take place in another taxpayer's calculation of taxable income.<sup>74</sup>

## 7. Conclusion

In summary:

- Section 24C provides temporary relief, in the form of an allowance which reverses in the following year of assessment, to taxpayers that receive income in advance of incurring the expenditure related to the earning of that income.
- The taxpayer bears the *onus* of proving the following –
  - the taxpayer's income in a particular year of assessment includes an amount of income received or accrued under a contract;
  - all or part of the advance income will be used to finance future expenditure which *will be incurred* by the taxpayer in performing the taxpayer's obligations under that contract or under two or more contracts that are so inextricably linked so as to satisfy "sameness"; and

<sup>74</sup> See sections 41 to 47 of the Act for details.

- the future expenditure when incurred will qualify for a deduction or, in the case of the acquisition of an asset, will qualify for any deduction under the Act.
- The contract may be a written contract or a verbal contract; however, in the latter case it may be more difficult to prove the existence of a contract and the rights and obligations flowing from it.
- The words “*will be incurred*” indicate that there is a high degree of probability and inevitability that the expenditure will be incurred by the taxpayer. A taxpayer must therefore be able to demonstrate that, although the expenditure is contingent at the end of the year of assessment in question, there is a high degree of certainty that the expense will in fact be incurred in a subsequent year. The facts of each case are critical. The degree of certainty required is unlikely to be met if performance under the contract is *not* contractually obligatory but is only *potentially* contractually obligatory because of an act or event other than just the taxpayer’s client or customer taking action.
- Assets already acquired do not represent future expenditure.
- Assets falling within the ambit of section 24C are those assets which will be acquired in order to perform under the specific contract giving rise to the advance income. The replacement of assets generally used in the taxpayer’s trade fall outside the ambit of section 24C.
- The amount of the section 24C allowance is equal to the amount of advance income which will be used to finance future expenditure, under one and the same contract, or under two or more contracts which may be so inextricably linked that they may satisfy the requirement of “sameness” under section 24C.
- The section 24C allowance may not exceed the amount of income received or accrued under the contract in a particular year of assessment. The amount of income received or accrued in a current year includes the reversal of the previous year’s section 24C allowance.
- The section 24C allowance is based on how much of the advance income will be used to finance future expenditure and may, therefore, never exceed the amount of income even if the contract is running at a commercial loss.
- It is not possible to be prescriptive on the methods used to calculate the amount of the section 24C allowance. However, in a number of cases the ‘gross cost method’ will be appropriate.
- Generally, the calculation of the section 24C allowance must be performed on a detailed contract-by-contract basis. However, there are limited circumstances in which it may be appropriate to perform the analysis at a higher level by taking a number of contracts into consideration.
- An assessment of whether section 24C is applicable must be performed annually taking into account up-to-date information.

- A decision made by the Commissioner under section 24C is subject to objection and appeal in accordance with Chapter 9 of the Tax Administration Act, 2011.<sup>75</sup>

**Leveraged Legal Products**  
**SOUTH AFRICAN REVENUE SERVICE**  
Date of 1<sup>st</sup> issue : 29 July 2014

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<sup>75</sup> Sections 104 and 107 of the TA Act, respectively.