Dear Sir/Madam

Enclosed is the SAICA National Tax Committee’s submission on the Draft Interpretation Note on section 24C Allowance for Future Expenditure on Contracts.

1. Preamble

1.1 The wording in “advance income” needs to be amended as follows:

“advance income” means income which is received by or accrues to a taxpayer in terms of a contract and which will be used to finance the expenditure which will be incurred in fulfilling his/her obligations in respect of that contract;

Whilst it commonly applies to income received in advance, the Act does not refer to it as such – it merely qualifies the receipt (or accrual) by stating that it must be in terms of a contract and must be income. It is suggested that the phrase “contract income” would be more appropriate.
1.2 The draft note uses the phrase “advance payment” in a number of places where the reference is really to what was defined as advance income. It is suggested that the note uses the concept consistently.

1.3 The phrase “the Act” is used in the draft note. It is clear from the context that it must be the Income Tax Act, but it would be appropriate to confirm that in the preamble.

2. Background

2.1 The following grammatical changes need to be made to these paragraphs contained in the “Background” section.

First paragraph
The Explanatory Memorandum stated that the purpose of section 24C was to empower “the Commissioner to make a deduction, by way of a reserve, in respect of any amount received under a contract which is to be utilised to finance future expenditure”. It is suggested that the first sentence in this paragraph should read as follows: “The nature of certain taxpayers’ businesses is that they receive amounts in terms of a contract which they will use to finance the expenditure they will incur in the future”.

Second paragraph
In the absence of section 24C the income would be fully taxable in the year of assessment received without any deduction for future expenditure. This is due to the fact that most sections require that the expenditure has to be actually incurred before a deduction is allowed [for example, section 11(a)] and, in addition, section 23(e) specifically prohibits the deduction of income transferred to any reserve fund or capitalised in any way.

Third paragraph
Section 24C was inserted in the Act as a relief measure to taxpayers who, because of the nature and special circumstances of their businesses, receive advance payments during a year of assessment and only incur related expenditure in a subsequent year of
assessment. The explanatory memorandum states that the reason for the insertion of section 24C is follows: ...

3. Application of the law

3.1 The following grammatical changes need to be made.

4.1 Income
A prerequisite for any allowance under section 24C is that the taxpayer concerned must have included an amount, which was received by or accrued to him/her in terms of a contract, in his/her income in the particular year of assessment. As the taxpayer will only incur some or all of the expenditure in a subsequent year of assessment, he/she seeks to claim the allowance.

Second paragraph comment
The following comment is made in the second paragraph of 4.1:

“It is considered likely that in most circumstances where an amount has been received in advance and is to be used to fund future expenditure that it will relate to an actual receipt of an amount and not the accrual of an amount.”

We do not agree as ‘gross income’ definition does not exclude accrued amounts in these circumstances.

In footnote 5 the following “paragraph n of the gross income definition” should be changed to: “paragraph (n) of...”

Example 1 – Income
Facts: ABC received income in advance of R1m in year one in respect of which a section 24C allowance of R0,6m was permitted. No additional amounts were received by or accrued to ABC under the contract in year two.

The example assumes that none of the future expenses were incurred in year two, i.e. the quantum of the future expenses remain at R0,6m.
4.1.1 A contract

Proposed revised wording for the 4th paragraph:

Oral contracts are valid where a written contact is not required in terms of a particular law. However, it may be difficult to prove the existence and terms of an oral contract due to the lack of evidentiary proof. A taxpayer wishing to invoke the provisions of section 24C must be able to prove the existence of a contract, the income received or accrued under that contract, the associated performance obligations and the expenditure related to performing those obligations, to the satisfaction of the Commissioner. SARS recognises that not all contracts are reduced to writing (for example, certain implicit unilateral contracts that are evidenced by a ticket, stamp, voucher etc.) but, where possible, it is recommended that taxpayers reduce their contracts to writing (for example, in a negotiated contract between two parties).

4.2.1 Expenditure which the Commissioner is satisfied was incurred in a subsequent year of assessment (…)

Proposed revised wording for last paragraph of (a)
A taxpayer seeking to claim a section 24C allowance will not yet have incurred the expenditure at the end of the year of assessment. However, he/she will need to satisfy the Commissioner that he/she will incur expenditure in a subsequent year of assessment – this aspect is discussed in 4.2.1(b).

Proposed revised wording for first paragraph of (b)
When applying the expenditure incurred principles discussed in 4.2.1(a) to section 24C, a taxpayer will need to demonstrate that he/she will spend an amount in the future, or will incur an unconditional legal liability to spend an amount, before the Commissioner will be satisfied that expenditure will be incurred in a subsequent year of assessment. The words “will be incurred” indicate that the Commissioner must be satisfied 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 of assessment.
Proposed revised wording for fourth, fifth and sixth paragraph of (b)

The facts and circumstances of each case vary significantly and it is therefore not possible to specify the industries or specific circumstances in which taxpayers will always be able to demonstrate and prove the required level of certainty required to invoke the provisions of section 24C. The facts of each case are critical to this determination. It is, however, noted that the degree of certainty required is unlikely to be met if the performance is not contractually obligatory but only potentially contractually obligatory due to a potential future act or event other than merely the potential threat of action against the taxpayer by his/her client or customer. It is phrased as follows in Income Tax in South Africa: “It is submitted that there must be in existence an enforceable and uncontingent obligation to perform under a contract, which performance will lead to the incurral of expenditure.”

The distinction can be a fine one, for example, in the case of a construction contract where a builder is contractually required to build the house which includes tiling the floors (that is, performance is obligatory) the cost of the tiles will be included in the future expenditure calculations. The degree of certainty required to satisfy the Commissioner that the expenditure will be incurred exists in that 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 disturb the degree of certainty. It may be that the colour will affect the quantification of the future expenditure if the cost of the tiles is affected by the colour thereof but it does not per se affect the level of certainty. In general, an obligation to perform remains unconditional where performance is merely dependent on the client taking action (for example, the client choosing the colour tiles) but it is not where 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 discussed in 4.2.5 and 4.2.6.

Example used – gift voucher

The example regarding gift vouchers must be changed as gift vouchers may no longer expire per the Consumer Protection Act.

(c) In performing his or her obligations under the contract in terms of which the income was received
Grammatical changes required:
The future expenditure must be incurred by the taxpayer in the performance of his or her obligations in terms of the same contract as the contract under which the income was received by or accrued to the taxpayer. The contract does not have to (and rarely will) stipulate exactly which 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 the taxpayer entered into rental and maintenance agreements (which the court assumed, without deciding, were one contract) in terms of which the customer agreed to rent copy machines for an agreed monthly rental and the taxpayer agreed to maintain the copy machines. Following the conclusion of the rental and maintenance agreements, the taxpayer ceded it rights to the future rental income in return for an upfront 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 in respect of the lump sum income as the performance of his or her obligations in respect of the rental and maintenance agreements was not directly related to the discounting agreement in terms of which the lump sum income was received.

In ITC 1697 the taxpayer, a share block company, received advance levy income from the share block holders in terms of a Usage Agreement and in return was required to fulfil certain obligations (for example, to attend to the repair, upkeep, control, management and administration of the company, the property and the immoveable property and to attend to the payment of any obligation in connection therewith such as salaries, rates, local authority charges like water and electricity). The court confirmed that the advance levies were received in terms of the Usage Agreement and the provisions of section 24C had to be applied in relation to that agreement. Section 24C did not apply to the contracts that the taxpayer had or would conclude with the suppliers of goods and services in order to perform under Usage Agreement.

4.2.2 Expenditure (not of a capital nature) is incurred in such a manner that the expenditure will be allowed as a deduction in a subsequent year
Grammatical changes required:
In terms of this provision, the expenditure 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 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 that:

4.2.3 Expenditure (of a capital nature) in respect of the acquisition of an asset
The future expenditure referred to here relates to the expenditure which will be incurred in respect of 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 replacement of assets generally used in the taxpayer’s trade will not qualify for an allowance under section 24C. It also does not relate to the deduction of a capital allowance or wear-and-tear allowance of an asset which has already been acquired (and the expenditure therefore already incurred).

Example 2 comments and recommended changes:

Example 2 – Acquisition of an asset
Facts: A taxpayer, BB (Pty) Ltd, entered into a two year contract with the local municipality for the construction of a road at the beginning of year one. The Contract price is R1 000 000. The municipality paid BB (Pty) Ltd an amount of R500 000 in the same year. The next payment of R300 000 was made in year two and the balance of R200 000 was paid in year three.

On the first day of year two BB (Pty) Ltd purchased a truck for R150 000 on the first day of year two, which was only be used in the construction of this road. The write-off period for this type of truck allowed by SARS is three years.

The example accepts that the R500 000 was received by BB (Pty) Ltd in order to buy the truck. It does not deal with other expenses that must be incurred by the company to perform in terms of the contract.
The result then is wrong in its treatment of the R150 000. It is correct that the R150 000 is the section 24C allowance and that it is added back in year 2. As is stated in the draft note this amount added back is treated as contract income (or advance income). Clearly an amount of R100 000 thereof will be allowed in year 3 and 4 and should therefore be deducted in terms of section 24C.

4.2.4 Application of section 24C to ceded contracts
Comment regarding the wording of the footnote: It is not possible to “ignore” the application of the corporate rule provisions in section 41 – section 47. It is probably meant that the sale of the business did not mean the requirements of sections 42, 44, 45 and 47 or the parties opted out.

4.2.5 Application of section 24C to warranty claims

Grammatical change recommended in last sentence of first paragraph:
The principles discussed in 4.2.1(b) are applicable to both of these types of warranties.

Grammatical changes recommended to fifth paragraph:
In ITC 1739 the taxpayer manufactured certain components which were supplied to original equipment manufacturers, who 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 affect 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:

Grammatical changes recommended to last paragraph:
In this case, the specific circumstances will determine whether the taxpayer will need to acquire the replacement asset (and will thus incur future expenditure) or whether the taxpayer will use assets already purchased and on hand (and will thus not incur future expenditure). However, as the event which gives rise to the warranty claim (for example, the equipment malfunctioning) is contingent and not merely dependent on the customer returning the item, a section 24C deduction for the possible expenditure arising from a warranty claim will not be
allowed. This is due to the fact that there is no certainty that the asset will malfunction and accordingly there is insufficient certainty that the related expenditure will be incurred in the future.

4.2.6 Application of section 24C to maintenance contracts

Grammatical changes to second, third and fourth paragraphs:
For example, the contract may only cover breakages or malfunction, i.e. a contingent event. In these circumstances the Commissioner will not be satisfied that the expenditure will be incurred in the future.

There are, however, circumstances in which the Commissioner will be satisfied that the expenditure will be incurred in the future, for example, in the case of a motor vehicle service plan where certain maintenance is required at regular intervals (assuming the client makes its motor vehicle available for the service to take place).

It is not clear why the following assumption is made: “assuming the client makes its motor vehicle available for the service to take place.” It is submitted that this is implied in the contract. Clearly it would be impossible to know if the client should decide not bring the vehicle in to claim the benefits. This should not impact on the section 24C allowance.

The future maintenance expenditure may qualify for a deduction under section 24C provided the other requirements of the section are met. The onus to satisfy the Commissioner in this regard is on the taxpayer.

5.1 The amount of future expenditure which in the Commissioner’s opinion relates to the amount of advance income

Grammatical changes to this section:
The principles discussed in 4.2 are relevant in determining what amounts constitute future expenditure.

Section 24C does not enable a taxpayer to delay his/her tax liability on that portion of advance income which represents the taxpayer’s profit or which was used to fund
expenditure that has already been incurred. This is due to the fact that those portions of the advance income will not be used to fund future expenditure.

Stated differently, taxpayers need to determine the quantum of the future expenditure which will be expended by the advance income in terms of the relevant contract and the taxpayer must be able to substantiate that claim. For example, assume a taxpayer receives 50% of the contract amount in year one and does not incur any expenditure. Although all the costs the taxpayer will incur in the future in performing his or her obligations under the contract are future expenditure, they do not all 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.

It is true that the full 50% may not be used to fund future expenses, but it is wrong to say that “they do not all constitute future expenditure.”

The use of the words “will be appropriate” is not appropriate in the note. As this note will be an official publication it creates a practice generally prevailing – refer to section 5 of the tax Administration Act. The wording in the Note should therefore be sufficiently clear to indicate the circumstances where this simplified method must be applied or it should be left out of the note completely.

**Grammatical changes to second paragraph following bullet points and last paragraph of section:**

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 will depend on the specific facts and circumstances. These estimates and calculations should contain sufficient detail to demonstrate that the expenditure included in the section 24C allowance is related to the performance of obligations in terms of the contract, that it only contains permitted types of expenditure (for example, excludes wear-and-tear allowances and items drawn from assets previously acquired) and that the items taken into account can be reviewed and audited.
The Commissioner does not require the taxpayer to deposit the funds received in advance into a separate bank account and only use the funds from that account to settle the expenditure incurred.

It is submitted that to do so would not be in accordance with the wording of section 25C which certainly does not require that.

Example 4 – is an example of a construction contract where the simplified method is used. It illustrates some of the problems of this method. Clearly the R30 000 spend in the year of the receipt should reduce the amount of the future expenses. It is suggested that the example be changed to one where no expenses were incurred in year 1. It is also not clear why the actual expenses exceed the estimate (R610 000 versus R500 000).

Example 5 raises a number of questions. One must accept that the contract price (the R275 000) does not accrue to the taxpayer. It is also not clear what was meant with “an ad hoc quality bonus awarded” – the result assumes that it was paid in year 1 which may be unlikely as the contract has not been completed in year 1. It also seems to include the bonus in the R110 000 receipt. The example then does not give an indication of the future expenses and the total expenses (actually incurred plus estimated) exceed the contract price. This just does not make sense. It is suggested that the example be changed.

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

Grammatical changes:
The section 24C allowance allowed is limited to the amount of income received or accrued under the contract in a particular year of assessment and not to the taxpayer’s taxable income prior to the determining the section 24C allowance.

This must of course be read in the context of the principle that the allowance granted in the previous year is seen as contract income of the current income year.
6. Reversal of the prior year’s section 24C allowance

Grammatical changes
As noted above, section 24C(3) provides that an allowance deducted in any year of assessment is deemed to be included in the taxpayer’s income in the succeeding year of assessment. This provision is not discretionary.

Generally, the claiming of the allowance in one year and the reversal in the next year takes place in the same taxpayer’s hands. However, where the operations to which the section 24C allowance applied were disposed of in terms of the corporate rules contained in section 41 – 47, the reversal of the allowance claimed in the previous year of assessment will take place in the acquitting taxpayer’s hands.

The same comment that was made earlier applies to example 8. The actual expenses of R60 000 should not be treated as future expenses.

7.1 Analysis on a contract-by-contract basis

Proposed grammatical changes to paragraphs following example:
There are situations where it may be very difficult to analyse the expenditure to be incurred and identity the specific contract to which it relates. There is however clearly an obligation to incur the expenditure in terms of an obligation to perform in terms of a specific contract. This may occur due to practical difficulties associated with analysing the expenditure in sufficient detail before it can be associated with a specific contract. Taxpayers may combine such expenditure as well as the advance income from the contracts to which it relates in order to determine the quantum of the future expenditure. Contrasted against that situation, when the exercise is performed for a contract to erect or build a specific asset, it is most likely practical, meaningful, realistic and necessary to analyse the contracts on an individual contract-by-contract basis. Also, if, for example, a particular machine will be purchased which is not generally used in the business but may be used on more than one contract, the cost of that machine can be allocated to the various contracts based on, where appropriate, the estimated hours of utilisation. This treatment takes account of the fact that building contracts are often not similar and have different obligations, revenue and cost profiles. It is critical that each separate contract must place an unconditional obligation/s for the taxpayer to perform and the
Commissioner must be satisfied that in performing those obligation/s the taxpayer will incur future expenditure. It may be appropriate to perform the analysis by combining similar contract with shared expenditure in order to determine the quantum of expenditure which will be funded from advanced income received. Taxpayers will need to consider their particular facts and circumstances to determine if the determination needs to be performed on a combined basis. These circumstances usually presents themselves in situations where the taxpayer enters into multiple contracts on a regular basis and the contracts are similar in scope and nature with the same or similar performance obligations, revenue profiles and cost profiles. Examples will include:

- Advance subscriptions for a particular magazine; or
- 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. It may however, also be reasonable to consider the obligations in terms of a specific contracts where the agreed terms or circumstances may require the application of the 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 there are any costs (or income) which 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), and items which have already been purchased and will be drawn from trading stock on hand at year-end would need to be excluded. In addition, known or anticipated price increases and decreases should be taken into account.

**Comment regarding the gift vouchers example:**
It is possible that the gift voucher is used to acquire an item which has a cost in excess of the value of the gift voucher. Surely the taxpayer should then be able to claim the full amount of the gift voucher under those circumstances.

Please do not hesitate to contact us, should you have any questions regarding the above.

Yours faithfully
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PROJECT DIRECTOR: TAX

The South African Institute of Chartered Accountants