

**THE DEDUCTIBILITY OF FUTURE EXPENDITURE  
ON CONTRACTS IN TERMS OF SECTION 24C**

By

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## THE DEDUCTIBILITY OF FUTURE EXPENDITURE ON CONTRACTS IN TERMS OF SECTION 24C

Section 24C of the Income Tax Act No. 58 of 1962 ('the Act') provides for a deduction of future expenditure that will be incurred by the taxpayer in the performance of his obligations under a contract from which the taxpayer derived income.

Due to uncertainties regarding the meaning of certain words and phrases used in section 24C, the first aim of this assignment was to determine the meaning of the word 'expenditure' and the phrase 'will be incurred' as used in section 24C. The second aim was to establish how a taxpayer will prove with certainty that he will incur future expenditure in the performance of his obligations under a contract. This was done by discussing the effect of contractual terms and other circumstances and by taking into account certain additional guidelines regarding the interpretation of section 24C provided for in *Interpretation Note: No. 78 ('IN 78')*.

It was established that the word 'expenditure' means the amount of money spent, including the disbursement of other assets with a monetary value. The word 'expenditure' also specifically includes the *voluntary* payments and disbursements of assets. The word 'expenditure' can also include a *loss* if the word 'loss' can be equated to the word 'expenditure'.

The phrase 'will be incurred' implies that the taxpayer will, in a subsequent year of assessment, have an unconditional obligation to pay for expenditure, which must arise from the taxpayer's obligations to perform under the contract.

Contractual terms and other circumstances can indicate whether there is certainty that future expenditure will be incurred as aforementioned. *Conditions* and *warranties* are contractual terms that indicate that there is uncertainty regarding the taxpayer's obligations to perform under the contract. A *time clause* in a contract can indicate that there is certainty regarding the taxpayer's obligations to perform under the contract. Similar contracts with similar *conditional* obligations to perform cannot be grouped together in order to determine the *probability*, and thus the certainty, that future expenditure will be incurred in the performance of the taxpayer's obligations under a contract. The *probability* that a taxpayer will perform his *unconditional* obligation under the contract must, however,

be proved in order to demonstrate that there is certainty regarding the incurral of the future expenditure.

*IN 78* does not specify whether a *loss* which can, in certain circumstances, be equated to the word 'expenditure', is deductible under section 24C. This should be clarified. The new undefined phrases (a *high degree of probability, inevitability, certainty* and *potentially contractually obligatory*), as used in *IN 78*, might cause confusion when interpreting section 24C. These phrases should be defined and it should be explained how the *high degree* will be measured.

Lastly, it was shown that an anomaly occurs regarding trading stock at hand at the end of a year of assessment, which will be utilised in a subsequent year of assessment in the performance of the taxpayer's obligations under a contract. Such trading stock does not represent 'future expenditure' and must be excluded from the section 24C allowance. However, due to the interplay between section 24C and section 22(1), the taxpayer does not receive any tax relief for the expenditure actually incurred to acquire the closing trading stock in the year in which such trading stock is acquired. It is, therefore, questioned whether the established interpretation of section 24C is in agreement with the Legislator's original intention with section 24C namely, to match income received under a contract with the related deductible expenditure.

## **DIE AFTREKBAARHEID VAN TOEKOMSTIGE ONKOSTE OP KONTRAKTE INGEVOLGE VAN ARTIKEL 24C**

Artikel 24C van die Inkomstebelastingwet No. 58 van 1962 ('die Wet') voorsien 'n aftrekking vir toekomstige onkoste wat deur die belastingpligtige aangegaan sal word in die nakoming van sy verpligtinge ingevolge 'n kontrak waaruit hy inkomste verkry het.

As gevolg van onsekerhede ten opsigte van die betekenis van sekere woorde en frases wat in artikel 24C gebruik word, was die eerste doelstelling van hierdie navorsingswerkstuk om die betekenis van die woord 'onkoste' en die frase 'aangegaan sal word', soos wat dit in artikel 24C gebruik word, te bepaal. Die tweede doelstelling was om vas te stel hoe 'n belastingpligtige met sekerheid sal bewys dat hy toekomstige onkoste sal aangaan in die nakoming van sy verpligtinge ingevolge 'n kontrak. Dit is gedoen deur die effek van kontraksbedinge en ander omstandighede te bespreek en deur sekere bykomende riglyne ten opsigte van die interpretasie van artikel 24C, soos vervat in Interpretasienota No. 78 ('IN 78'), in ag te neem.

Daar is vasgestel dat die woord 'onkoste' die bedrag van geld wat bestee word, insluitend die uitbetaling van ander bates met 'n geldwaarde, beteken. Die woord 'onkoste' sluit ook spesifiek *vrywillige* betalings en uitbetalings van bates in. Die woord 'onkoste' kan ook 'n *verlies* insluit, indien die woord 'verlies' gelyk gestel kan word aan die woord 'onkoste'.

Die frase 'aangegaan sal word' impliseer dat die belastingpligtige, in 'n daaropvolgende jaar van aanslag, 'n onvoorwaardelike verpligting sal hê om vir onkoste te betaal. Hierdie onkoste moet ontstaan weens die belastingpligtige se verpligtinge ingevolge die kontrak.

Kontraksbedinge en ander omstandighede kan aandui of daar sekerheid is dat die toekomstige onkoste, soos hierbo genoem, aangegaan sal word. *Voorwaardes* en *waarborges* is kontraksbedinge wat daarop dui dat daar onsekerheid is rakende die belastingpligtige se verpligtinge om ingevolge die kontrak op te tree. 'n *Tydsklousule* in 'n kontrak kan aandui dat daar sekerheid is rakende die belastingpligtige se nakoming van sy verpligtinge ingevolge die kontrak. Soortgelyke kontrakte, met soortgelyke *voorwaardelike* verpligtinge kan nie saam gegropeer word ten einde te bepaal of dit *waarskynlik*, en gevolglik seker is dat toekomstige onkoste in die nakoming van 'n belastingpligtige se verpligtinge ingevolge die kontrak aangegaan sal word nie. Die *waarskynlikheid* dat 'n

belastingpligtige sy *onvoorwaardelike* verpligting ingevolge die kontrak sal nakom moet egter bewys word ten einde aan te dui dat daar sekerheid is dat toekomstige onkoste aangegaan sal word.

*IN 78* spesifiseer nie of 'n *verlies* wat, in sekere omstandighede, gelyk gestel kan word aan die woord 'onkoste', ingevolge artikel 24C aftrekbaar is nie. Duidelikheid hieromtrent moet verskaf word. Die nuwe, ongedefinieerde frases ('n *hoë graad van waarskynlikheid, onafwendbaarheid, sekerheid* en *potensieel kontraktueel verpligtend* (vry vertaal)), soos in *IN 78* gebruik, kan moontlik verwarring veroorsaak wanneer artikel 24C geïnterpreteer word. Hierdie frases moet gedefinieer word en daar moet verduidelik word hoe 'n *hoë graad* gemeet gaan word.

Laastens blyk dit dat 'n teenstrydigheid ontstaan ten opsigte van handelsvoorraad op hande aan die einde van 'n jaar van aanslag, wat in 'n daaropvolgende jaar van aanslag deur die belastingpligtige in die nakoming van sy verpligtinge ingevolge 'n kontrak gebruik sal word. Sodanige handelsvoorraad verteenwoordig nie 'toekomstige onkoste' nie en moet by die artikel 24C toelaag uitgesluit word. Die belastingpligte ontvang egter, weens die wisselwerking tussen artikel 24C en artikel 22(1), nie 'n belastingverligting vir die onkoste werklik aangegaan in die jaar waarin sodanige handelsvoorraad verkry is nie. Dit word dus bevraagteken of die bewese interpretasie van artikel 24C in ooreenstemming is met die Wetgewer se oorspronklike bedoeling met artikel 24C, naamlik, om inkomste ontvang ingevolge 'n kontrak met die verwante aftrekbare uitgawes te paar.

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## ABBREVIATIONS AND TERMINOLOGY

‘BPR’ –	Binding Private Ruling, as issued by SARS;
‘ITC’ –	Income Tax Case No.;
‘OED’ –	Oxford English Dictionary;
‘SARS’ –	the South African Revenue Service, as defined in section 1 of the Income Tax Act;
‘SATC’ –	the ‘South African Tax Cases Reports’, as issued by LexisNexis;
‘the Act’ –	the Income Tax Act No. 58 of 1962 (as amended);
‘the Commissioner’ –	the Commissioner for the South African Revenue Service, as defined in section 1 of the Income Tax Act;
‘IN 78’ –	Interpretation Note: No. 78; Allowance for future expenditure on contracts;
‘the <i>Explanatory Memorandum</i> ’ –	<i>Explanatory Memorandum on the Income Tax Bill of 1980.</i>

All references to relevant pages in tax cases are the pages as given in the SATC, unless otherwise stated.

All references to ‘section’ are to the sections in the Income Tax Act, unless otherwise stated.

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## CHAPTER 1: INTRODUCTION

### 1.1 Background

Section 24C of the Income Tax Act No. 58 of 1962 ('the Act') provides for a deduction of future expenditure that will be incurred by the taxpayer in the performance of his obligations under a contract from which the taxpayer derived income (De Koker & Williams, 2011:par 8.60).

Section 24C was introduced into the Act in 1980. According to the *Explanatory Memorandum on the Income Tax Bill of 1980* (SARS, 1980:9) ('the *Explanatory Memorandum*'), the purpose of section 24C is to address situations where income is received or accrued in terms of a contract in one year of assessment, and the income is to be utilised to finance future expenditure. The *Explanatory Memorandum* refers to the situation in the construction industry where a contractor, prior to the commencement of the contract, receives an advance payment to enable him to purchase material and equipment. This results in situations where such advance payments are recognised as income in the year of assessment, but are not matched by related deductible expenditure in the same year of assessment. Consequently, the full amount of the income is subject to taxation in the year of assessment in which it was received. Section 24C was inserted to empower the Commissioner of SARS ('the Commissioner') to allow a deduction in respect of any amount received under a contract, which will be utilised by the taxpayer to finance future expenditure in the performance of his obligations under that contract. Refer to Annexure A for the exact wording of section 24C.

The phrase 'future expenditure' in relation to any year of assessment is defined in section 24C(1). The requirements that the expenditure under contention must meet, are as follows:

- There must be an amount of expenditure; and
- The Commissioner must be satisfied that the amount will be incurred after the end of the year of assessment; and
- The amount will be allowed as a deduction from income in a subsequent year of assessment (section 24C(1)(a)); or

- The amount is in respect of the acquisition of any asset for which any deduction will be admissible under the provisions of the Act (section 24C(1)(b)).

Sections 24C(1)(a) and (b), accordingly, stipulate that future expenditure which will be incurred must be deductible in terms of a provision in the Act in a subsequent year of assessment. Sections 24C(1)(a) and (b) thus, indirectly and, *inter alia*, refer to sections 11(a) to 11(w) of the Act. These sections list deductions that are allowed in determining the taxable income of a taxpayer that engages in the carrying on of a trade. Section 11(x) brings within the scope of section 11 all other amounts allowed as a deduction from the income of the taxpayer in terms of any other provision in Part I of the Act (Stiglingh, Koekemoer, Van Schalkwyk, Wilcocks & De Swardt, 2014:166). Section 11(a) is the so-called general deduction formula and allows for a deduction of expenditure and losses, actually incurred, in the production of the income, provided such expenditure and losses are not of a capital nature. In *Port Elizabeth Electric Tramway Co Ltd v Commissioner of Inland Revenue* 8 SATC 13 (*'Port Elizabeth Electric Tramway Co Ltd v CIR'*) the court specified that sections 11(a) and 23(g) should be read together. Section 23(g) must, therefore, also be taken into account when interpreting section 24C, since it prohibits the deduction of expenditure that is not laid out or expended for the purpose of trade. Although the scope of sections 24C(1)(a) and (b) is very wide, for the purpose of this assignment, the scope of a deductible amount will be limited to an amount that is deductible in terms of section 11(a).

In terms of section 24C(2), the following requirements must be complied with in order to utilise the section 24C allowance:

- The income of any taxpayer, in any year of assessment, must include or consist of an amount received by or accrued to him in terms of any contract; and
- The Commissioner must be satisfied that such amount will be utilised in whole or in part to finance future expenditure; and
- Such future expenditure will be incurred by the taxpayer in the performance of his obligations under such contract.

Although the phrase 'future expenditure' is defined in section 24C(1) of the Act, the word 'expenditure' is not. Other key phrases used in section 24C(2) that are not defined by the Act are 'will be incurred' and 'in the performance of his obligations under such contract'.

For the purpose of interpreting and correctly applying section 24C, it is important to understand the meaning of these phrases.

Section 24C(3) stipulates that any deduction allowed in any year of assessment in terms of section 24C(2) must be included in the income of the taxpayer in the following year of assessment.

The Commissioner has, in terms of sections 24C(1) and (2), the discretion to decide whether the requirements of section 24C have indeed been complied with, and to subsequently decide on the amount of the deduction. In terms of section 102(1)(b) of the Tax Administration Act No. 28 of 2011, the burden to prove to the Commissioner that the section 24C allowance should be allowed, rests on the taxpayer.

*Interpretation Note: No. 78, Allowance for future expenditure on contracts ('IN 78')* (SARS, 2014(3)) was issued by SARS in July 2014 after comments from the public on the first and second *Draft Interpretation Note on section 24C* were considered. *IN 78* discusses the requirements of section 24C and also provides guidance on the interpretation and application of section 24C. In *IN 78*, SARS introduces new guidelines to indicate when there will be certainty that expenditure 'will be incurred in a subsequent year of assessment', as required by section 24C. Furthermore, *IN 78* addresses the taxpayer's obligations to perform under a contract. *IN 78* also indicates which expenditure may not be included in the section 24C allowance. *IN 78* further includes references to specific types of contracts and gives examples to explain SARS's interpretation of section 24C. Whether these guidelines on the interpretation of section 24C and the examples given by SARS are in agreement with the Legislator's intention in respect of section 24C, has not yet been determined. To date, no research has been done to compare *IN 78* with section 24C.

Referring to the requirements of sections 24C(1) and (2) and to *IN 78*, it is clear that there are some uncertainties regarding the meaning of the following words and phrases used in section 24C:

- expenditure
- will be incurred
- by the taxpayer in the performance of his obligations under a contract.

The meaning of these words and phrases are important when interpreting and correctly applying section 24C and, therefore, requires investigation.

## 1.2 Research question

To address the uncertainties that exist regarding the meaning of certain words and phrases used in section 24C, and to determine how a taxpayer will be able to prove that he will incur future expenditure in the performance of his obligations under a contract, the following three research questions are identified:

- What is the meaning of the word ‘expenditure’, and the phrase ‘will be incurred’ as used in section 24C?
- What indicators will serve to demonstrate that future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract? This research question will be addressed by exploring the following additional questions:
  - What effect do contractual terms in the contract have on the certainty that the taxpayer will perform his obligations under a contract and on the certainty of the incurral of the related future expenditure?
  - Which circumstances indicate that there is certainty that the future expenditure will be incurred?

The element of certainty will be addressed by referring to the following aspects:

- The definite connection that must exist between the incurral of future expenditure and the obligations to perform under the contract;
  - The contingent liability and the conditional obligation to perform under a contract;
  - The quantifiability of the future expenditure;
  - The certainty that future expenditure will be incurred under warranty contracts and maintenance and repair contracts; and
  - The effect of grouping similar contracts with conditional obligations to perform together in order to determine, based on historical data, the certainty that the future expenditure will be incurred.
- Does *IN 78* introduce any new guidelines, addressing the aforementioned research questions, and are there any shortcomings to these new guidelines?

### 1.3 Literature review

There are no authoritative higher court case decisions (Provincial Division of the High Court or the Supreme Court of Appeal) on section 24C. It is, however, meaningful to study available Tax Court cases as this provides insight to the Commissioner's interpretation of section 24C. It also sheds light on the Court's decisions in circumstances where the taxpayer and the Commissioner disagreed on the interpretation of section 24C.

Each of the identified research questions is now briefly discussed in more detail, based on available court cases and academic writing.

- What is the meaning of the word 'expenditure', as used in section 24C?

The Legislator used the word 'expenditure' in section 24C. The word is not defined in the Act. The word is also used in section 11(a). Section 11(a) refers to the deductibility of expenditure and losses actually incurred in the production of income. In *Joffe & Co (Pty) Ltd v Commissioner of Inland Revenue* 13 SATC 354 ('*Joffe & Co (Pty) Ltd v CIR*') Watermeyer CJ stated that, in relation to trading operations, expenditure usually refers to the voluntary payments of money, whereas losses are sometimes used to signify a deprivation suffered by the party concerned, usually an involuntary deprivation. Watermeyer CJ explained the interplay between expenditure and losses as follows:

[W]hen trading operations cause damage to third parties and this damage has to be made good, then the payment which is made in satisfaction of such damage may properly be called a loss, but when the payment has been made then it can also properly be called an expenditure. (360)

Watermeyer CJ highlighted the voluntary nature of expenditure and the involuntary nature of losses, and, in the case of payments for damages, he equated the words 'loss' and 'expenditure'. This is important, because section 24C only refers to the word 'expenditure' and it is unclear if, in the context of section 24C, 'expenditure' includes or excludes 'losses'.

In *ITC 1739 65 SATC 43 ('ITC 1739')* the taxpayer wished to apply section 24C, however, the Commissioner disallowed the deduction. Joffe J held that the costs incurred to honour the commitment in terms of a warranty contract are a *loss* and not *expenditure* and, therefore, disallowed the section 24C deduction. This was, however, criticised by JutaLaw (*Case no. 10723 2003 (1) JTLR 1 (GSpCrt) ('Case no. 10723')*), who held that the taxpayer had to incur *expenditure* to manufacture trading stock to replace the defective parts.

When comparing the facts in *ITC 1739* with Watermeyer CJ's example in *Joffe & Co (Pty) Ltd v CIR*, the honouring of the warranty contract in *ITC 1739* can be regarded as a *loss*, which is in agreement with the judgment of Joffe J. However, the payments made to manufacture the stock that must be supplied in terms of a contract that the taxpayer voluntarily agreed to can also be regarded as *expenditure*, which is in agreement with the view of JutaLaw on *ITC 1739*. There is, consequently, uncertainty about the Legislator's intention with the word 'expenditure', as used in section 24C. The meaning of the word 'expenditure', as used in section 24C, will be addressed in chapter 2.

- What is the meaning of the phrase 'will be incurred', as used in section 24C?

The phrase 'will be incurred' is not defined in the Act. The *Explanatory Memorandum* indicates that section 24C provides for an allowance that will match the income from the contract in year one with future *deductible* expenditure. The taxpayer has, therefore, not yet incurred the deductible expenditure at the end of year one, but will incur deductible expenditure in a future year of assessment.

Section 11(a), the general deduction formula, lists the requirements for deductible expenditure. It, *inter alia*, refers to expenditure that must be actually *incurred*. Cloete JA in *Ackermans Ltd v Commissioner for South African Revenue Service 73 SATC 1 ('Ackermans Ltd v C:SARS')* defined 'expenditure *incurred*' as the undertaking of an *obligation to pay* or (which amounts to the same thing) the *actual incurring of a liability*.

Exactly what the phrase 'will be incurred', as used in section 24C, entails will be addressed in chapter 2.

- What indicators will serve to demonstrate that future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract?

The taxpayer must prove to the Commissioner that, in terms of section 24C(2), the future expenditure will be incurred in the performance of the taxpayer's obligations under a contract. This will be addressed by the following two questions:

- What effect do contractual terms in the contract have on the certainty that the taxpayer will perform his obligations under a contract and on the certainty of the incurral of the related future expenditure?

Contracting parties express their intention to create specific obligations in their contract through the use of terms or stipulations (Van der Merwe, Van Huyssteen, Reinecke & Lubbe, 2007:278). A condition is a contractual term that qualifies the continued existence and operation of a contractual obligation, subject to the occurrence, or not, of an uncertain future event (Van Huyssteen, Van der Merwe & Maxwell, 2010:141). According to Van Huyssteen *et al.* (2010:143), it is generally recognised that an obligation exists despite the fact that the contract contains a suspensive condition. However, an obligation that is suspended by a condition cannot be enforced until fulfilment of the condition and, therefore, cannot be validly performed. Section 24C(2) only refers to 'obligations' under a contract and does not limit the *obligations* to *unconditional obligations*. The effect of conditions and other contractual terms on the certainty that the taxpayer will perform his obligations under a contract and on the certainty of the incurral of related future expenditure, will be addressed in chapter 3.

- Which circumstances indicate that there is certainty that the future expenditure will be incurred?
  - In *ITC 1527 54 SATC 227* ('*ITC 1527*') the taxpayer carried on the business, *inter alia*, of a furniture dealer who sold furniture under instalment sales agreements. Separate to the sales transaction, a two year guarantee was also provided to the customers. The taxpayer allocated various overhead expenditure, which he would incur in the future

to service the instalment sales agreements, to the section 24C allowance. The Commissioner was, however, not satisfied with the taxpayer's allocation of the overhead expenditure to the section 24C allowance. Melament J held that the taxpayer could not provide evidence that the contract imposed any obligation on him to incur the overhead expenditure in question.

The definite connection that must exist between the incurral of future expenditure and the obligations to perform under the contract, and its effect on the certainty that future expenditure will be incurred, will be discussed in chapter 4.

- In *ITC 1601* 58 SATC 172 (*'ITC 1601'*) it was stated that if a taxpayer only has a *contingent liability*, it will not satisfy the requirement that the future expenditure 'will be incurred' in terms of section 24C. Clegg and Stretch (2011:par 11.11.7) criticised the decision in *ITC 1601* not to allow contingent expenditure as follows:

If expenditure is not contingent, then there will be no need for the section, as the liability would be absolute and a deduction under section 11(a) could be claimed. The wording requires the Commissioner to be satisfied that expenditure 'will be incurred after the end of such year', making it clear that it is the incurral itself which arises thereafter, and which must, by definition, be *uncertain* and contingent as at the end of the year in question. 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. (own emphasis)

The difference between these two arguments thus revolves around the context in which the reference to a *contingent liability* was used. *ITC 1601* merely stated that if a taxpayer has a *contingent liability* it will not indicate that the future expenditure 'will be incurred' in terms of section 24C. *ITC 1601* does not specify whether it refers to a contingent liability to pay

for expenditure or a contingent liability to perform under the contract. Clegg & Stretch (2011:par 11.11.7), however, refer to the taxpayer's obligation to perform under the contract, which will lead to the incurral of expenditure, which may not be contingent if a taxpayer wants to satisfy the Commissioner that future expenditure 'will be incurred'.

The difference between a contingent liability and a conditional obligation to perform under a contract, and their effect on the certainty that future expenditure will be incurred, will be discussed in chapter 4.

- In *ITC 1601* it was stated that a *clear measure of certainty* must exist as to whether the expenditure in contention is *quantified or quantifiable*. In *Commissioner of Inland Revenue v Edgars Stores Ltd* 48 SATC 89, ('*CIR v Edgars Stores Ltd*'), dealing with the deductibility of expenditure in terms of section 11(a), it was held that if an unconditional liability was incurred, but it cannot be quantified, the amount must be estimated based on available information and claimed in that tax year. This established the principle that the deduction in terms of section 11(a) does not depend on the quantifiability of the expenditure, provided that a reliable estimate of the expenditure can be made.

Whether the same principle can be applied to section 24C, and the effect of the quantifiability of the future expenditure on the certainty that future expenditure will be incurred, will be discussed in chapter 4.

- In *ITC 1601* the taxpayer's standard conditions of offer and sale contained a warrant against defective workmanship and materials supplied. The Commissioner did not allow the section 24C allowance for possible future expenditure to be incurred under a warranty in a contract. In *ITC 1667* 61 SATC 439 ('*ITC 1667*') the taxpayer rented out equipment under a rental contract and he provided, under a separate contract, for the maintenance of the equipment during the duration of the rental agreement. The Commissioner disallowed the deduction and, *inter alia*, held that the incurral of the maintenance expenditure was *conditional* upon the client using the equipment.

The certainty that future expenditure will be incurred under warranty contracts and maintenance and repair contracts, will be discussed in chapter 4.

- *Special Board Decision No. 129* dealt with section 24C. The taxpayer sold policies and earned commission on all his sales. The taxpayer, however, had an obligation to refund the commission if the policies were cancelled within two years. The taxpayer estimated his expected obligation to refund the commission based on the cancellation history. It was held that the amounts that the taxpayer claimed in terms of section 24C did not represent an obligation that would definitely be incurred. The amount referred to an obligation, which had not yet vested. It was also held that the fact that reliable data was available to enable a reasonably accurate projection of cancellation figures did not change the character of the obligation. The obligation of the taxpayer remained *contingent* in relation to each individual policy. The section 24C allowance was not allowed.

The effect of grouping similar contracts with conditional obligations to perform together, in order to determine, based on historical data, the certainty that future expenditure will be incurred, will be discussed in chapter 4.

- Does *IN 78* introduce any new guidelines, addressing the aforementioned research questions, and are there any shortcomings to these new guidelines?

*IN 78* discusses each requirement of section 24C and provides, *inter alia*, the following *new* guidelines on the interpretation of section 24C:

- Paragraph 4.2.1(a) of *IN 78* states that it is important to distinguish between expenditure and losses, because the two are different and section 24C only applies to ‘future expenditure’. *IN 78* further refers to *designed expenditure*, representing money voluntarily spent and *fortuitous expenditure*, representing ‘money involuntarily spent because of some mischance or misfortune which has overtaken the taxpayer’.

- Paragraph 4.2.1(b) explains the meaning of the phrase 'will be incurred in a subsequent year of assessment'. It states that the Commissioner must be satisfied that there is a *high degree of probability and inevitability* that the expenditure will be incurred. There must also be a *high degree of certainty* that the expenditure will be incurred in a subsequent year of assessment.
- Paragraph 4.2.1(b) of *IN 78* also addresses the taxpayer's obligations to perform under a contract. It seems that, through *IN 78*, the Commissioner is attempting to limit the application of section 24C to expenditure for which the taxpayer has an *unconditional contractual obligation*, as opposed to a *potential contractual obligation*. According to *IN 78*, where there is only a *potential contractual obligation*, the *degree of certainty* required for the deduction to be allowed in terms of section 24C is unlikely to be met. *IN 78* also states that an obligation to perform in terms of a contract will be unconditional where the performance of the taxpayer is merely dependent on the client taking action.

In chapter 5 these aforementioned new guidelines, introduced by *IN 78*, are discussed and any shortcomings to these new guidelines are emphasised.

- It is clear from paragraphs 4.2.3, 4.2.5 and 7.1 of *IN 78* that SARS is of the opinion that trading stock on hand at the end of the year of assessment, which will be utilised by a taxpayer in the performance of his obligation under the contract, in a subsequent year of assessment, will not be included in the section 24C allowance as 'future expenditure'.

Chapter 5.4 discusses the interplay between section 24C and trading stock.

#### **1.4 Research goals**

The aim of this assignment is to address the uncertainties that exist regarding the meaning of certain words and phrases used in section 24C, and to determine how a taxpayer will be able to prove that he will incur future expenditure in the performance of his obligations under a contract. In order to achieve this goal, this study will focus on the following:

- To provide a basic understanding of the meaning of the phrases 'expenditure and losses' and 'actually incurred', with reference to its meaning in section 11(a). This will serve as a basis from which to determine the meaning of the word 'expenditure' and the phrase 'will be incurred', as used in section 24C.
- To determine what indicators will serve to demonstrate that future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract. This will be done with reference to:
  - The contractual terms in the contract and the effect that they may have on the certainty that the taxpayer will perform his obligations under a contract and on the certainty of the incurral of the related future expenditure.
  - The circumstances which indicate that there is certainty that the future expenditure will be incurred. Specific reference will be made to:
    - The definite connection that must exist between the incurral of future expenditure and the obligation to perform under the contract;
    - The contingent liability and the conditional obligation to perform under a contract;
    - The quantifiability of the future expenditure;
    - The certainty that future expenditure will be incurred under warranty contracts and maintenance and repair contracts; and
    - The effect of grouping similar contracts with conditional obligations to perform together, in order to determine, based on historical data, the certainty that the future expenditure will be incurred.
- To identify and discuss any new guidelines, provided for by *IN 78* on the interpretation of section 24C, which address the aforementioned research goals, and to emphasise any shortcomings in these new guidelines.

## 1.5 Research method

The research will consist of a literature review of historical data. This will include relevant legislation, the *Explanatory Memorandum*, Income Tax and other court cases, Binding Private Rulings, *IN 78* and the opinions of acknowledged law and tax practitioners. Recognised journals and textbooks will also be consulted.

## 1.6 Assumptions and limitations of scope

- The scope of a deductible amount, in terms of sections 24C(1)(a) and (b), will be limited to an amount that is deductible in terms of section 11(a).
- This study will not focus on the calculation of the amount of the allowance deductible under section 24C.
- This study is not an in-depth investigation of the Law of Contract. When reference is made to *a contract* or the *obligation created to perform in terms of the contract*, it will be assumed that all the requirements for a valid contract have been met.

## 1.7 Chapter outline

Chapter 2 discusses all the elements of section 24C, highlighting the requirements that must be met before a taxpayer can apply the section. These are then compared with the requirements of section 11(a) to identify similarities and differences between these two sections. The meaning of the phrases ‘expenditure and losses’ and ‘actually incurred’, as found in section 11(a), are discussed to form a basis for the interpretation of the word ‘expenditure’ and the phrase ‘will be incurred’, as used in section 24C. This chapter concludes on the meaning of the word ‘expenditure’ and the phrase ‘will be incurred’, as used in section 24C.

Chapter 3 briefly discusses the burden that rests on the taxpayer to prove to the Commissioner that the requirements of section 24C are met. The remainder of the chapter focuses on the taxpayer’s obligations to perform under the contract, the performance of which must lead to the incurral of future expenditure. The following aspects are addressed: the meaning of the words ‘contract’, ‘obligation’ and ‘performance’; the effect of contractual terms on the certainty that the taxpayer will perform his obligations under a contract and on the certainty of the incurral of the related future expenditure. This will be done to determine whether the contractual terms will serve as indicators to demonstrate whether there is certainty that the future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract.

Chapter 4 discusses other circumstances that indicate that future expenditure 'will be incurred', as required in section 24C. Available Tax Court cases and Binding Private Rulings on section 24C are analysed and discussed to determine in which circumstances the Commissioner and the Courts were satisfied that there was certainty that future expenditure would be incurred by the taxpayer in the performance of his obligations under the contract.

In chapter 5, new guidelines provided for by *IN 78* are discussed with specific reference to the interpretation of the word 'expenditure' and any new indicators that can serve to demonstrate that future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract. Shortcomings to these new guidelines are emphasised and, if necessary, suggestions regarding these guidelines are provided. Lastly, chapter 5 discusses the interplay between section 24C and trading stock.

Chapter 6 is the concluding chapter. It contains a summary of the research conducted during the study and conclusions on the identified research questions.

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## **CHAPTER 2: REQUIREMENTS OF SECTION 24C AND SECTION 11(a), THE MEANING OF 'EXPENDITURE', 'ACTUALLY INCURRED' AND 'WILL BE INCURRED'**

### **2.1 Introduction**

Section 24C was inserted into the Act to empower the Commissioner to allow a deduction in respect of any amount of income received by or accrued to a taxpayer under a contract, which is to be utilised to finance future expenditure in the performance of his obligations under such contract. The meaning of the words used by the Legislator in section 24C is important when interpreting this section to correctly apply its provisions in the calculation of the taxpayer's taxable income.

In this chapter the basis for the interpretation of words used by the Legislator is briefly discussed to form the foundation for the interpretation of the words in section 24C. The requirements of section 24C are listed and discussed and subsequently compared with the requirements of section 11(a) to identify similarities and differences between these two sections. The meaning of the phrases 'expenditure and losses' and 'actually incurred', as found in section 11(a), are discussed to form a basis for the interpretation of the word 'expenditure' and the phrase 'will be incurred', as used in section 24C. This chapter concludes with the meaning of the word 'expenditure' and the phrase 'will be incurred', as used in section 24C.

### **2.2 Interpretation of words used by the Legislator**

Owing to the very nature of language, the meaning of words used by the Legislator is often not entirely clear (De Koker & Williams, 2011:par 25.1B). When the meaning of words is uncertain, judicial decisions are used to clarify the law (Stiglingh *et al.*, 2014:9). When interpreting the law, there are two main approaches of interpretation that are applied by the courts, namely the literal approach and the contextual approach.

In terms of the literal approach, the interpreter concentrates on the plain language of the provision of the Act (De Koker & Williams, 2011:par 25.1A). Nicholas JA held in *R Koster & Son (Pty) Ltd & Another v Commissioner for Inland Revenue* 47 SATC 23 that, when interpreting a provision in the Act:

[T]he plain meaning of its language must be adopted unless it leads to some absurdity, inconsistency, hardship or anomaly which from a consideration of the enactment as a whole a court of law is satisfied the Legislature could not have intended. (32)

When the literal rule gives rise to absurdity the courts may depart from the effect of the ordinary meaning of the word to the extent that is necessary to remove the absurdity and to give effect to the intention of the Legislator (De Koker & Williams, 2011:par 25.1B).

In terms of the contextual approach, the purpose of the legislation is determined by taking all the surrounding circumstances and resources into account (Stiglingh *et al.*, 2014:11). From as early as 1560, the courts have stated that, when determining the meaning of an enactment, the significance of 'the purpose' is regarded as being of greater importance than the actual letter of the language used (Kellaway, 1995:68).

Section 39(2) of the Constitution of the Republic of South Africa Act 108 of 1996 ('the Constitution') determines that every court must promote the spirit, purport and objectives of the Bill of Rights when interpreting legislation. This is an indication that the contextual approach must be followed when interpreting legislation, including the Income Tax Act in South Africa (Stiglingh *et al.*, 2014:11). According to Mdumbe (2004:481), when interpreting legislation, the starting point remains reading the text. The courts should, however, not confine themselves to the wording of the text. The broader context of the legislation should be consulted in order to establish its purpose, even if the words that have been used by the legislature are clear and unambiguous (Mdumbe, 2004:481).

Following the aforementioned, a contextual approach will be followed when interpreting section 24C. The text will be read to gain an understanding of the meaning of the words used by the Legislator. The plain and ordinary meaning of the words will be used, unless it is evident that this is in conflict with the intention of the Legislator. Further insight into the purpose of section 24C will be gained from the *Explanatory Memorandum* on section 24C. The purpose of the *Explanatory Memorandum* is to provide the background, reasons for and details of proposed amendments to legislation (SARS, 2014(2)). Therefore, the *Explanatory Memorandum* is incorporated when determining the meaning of the words and phrases used in section 24C.

## 2.3 Section 24C

Section 24C consists of three sub-sections. Section 24C(1) contains the requirements of the phrase 'future expenditure'. Section 24C(2) contains the requirements that must be met before the section 24C allowance will be permitted. Section 24C(3) specifies how the allowance that has been granted in a specific year of assessment should be treated in the following year of assessment. Refer to Annexure A for the actual text of section 24C.

In 2.3.1 – 2.3.3 the requirements, as contained in each sub-section of section 24C, are listed. Key words and phrases used by the Legislator in each requirement are then discussed. Words and phrases of which the meaning is unclear will be highlighted for further discussion in this assignment.

### 2.3.1 Requirements of section 24C(1)

Section 24C(1) defines 'future expenditure' in relation to any year of assessment. The future expenditure under contention must meet the following three requirements:

- There must be an amount of *expenditure*.

Although section 24C(1) defines 'future expenditure', the word 'expenditure' itself is not defined in section 24C or in the Act. It is important to know which amounts are included in the meaning of the word 'expenditure'. The word 'expenditure' is discussed in 2.5.

- The Commissioner must be *satisfied* that the amount *will be incurred* after the end of *such year of assessment*.

According to section 24C(1), the Commissioner has the discretion to decide whether the expenditure will be incurred after the end of the year of assessment. The burden to prove to the Commissioner that the requirements of section 24C are met is discussed in chapter 3.

The phrase 'will be incurred' is used in conjunction with 'after the end of such year of assessment'. It, therefore, indicates *when* the expenditure must be *incurred*. The word 'incurred' is, however, not defined in the Act and is discussed in 2.6.

The phrase 'such year of assessment' refers to the year of assessment in which the taxpayer received the income from the contract and in which the section 24C allowance will be deducted. The *incurral* of the expenditure under contention must, therefore, be *after* the end of the year of assessment in which the income in terms of the contract is received or accrues or, otherwise stated, in a *subsequent year of assessment*. Hereafter, reference will only be made to a *subsequent year of assessment*. It follows that 'future expenditure' refers to *expenditure that will be incurred in a subsequent year of assessment*. A 'year of assessment' is defined in the Act and, *inter alia*, means any year or other period in respect of which any tax or duty leviable under the Act is chargeable.

- The amount of expenditure must meet either the requirement of section 24C(1)(a) or the requirement of section 24C(1)(b).

Section 24C(1)(a) determines that the amount of expenditure must be allowable as a deduction from income in a subsequent year of assessment. Section 24C(1)(a), therefore, does not limit the scope of the deductible expenditure to a specific provision in the Act. An example under section 24C(1)(a) would be future salaries and wages to be paid in the performance of a trading contract (Meyerowitz, 2008:12-41).

Section 24C(1)(b) determines that the amount of expenditure must be in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of the Act. An example of section 24C(1)(b) expenditure would be the future purchase of capital assets, for example machinery and equipment, which will be used by the taxpayer in the performance of his obligations under the contract<sup>1</sup>.

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<sup>1</sup> For the purposes of this assignment, the scope of a deductible amount in terms of sections 24C(1)(a) and (b) will be limited to an amount that is deductible in terms of section 11(a).

### 2.3.2 Requirements of section 24C(2)

Section 24C(2) provides that the following three requirements must be met in order to utilise the section 24C allowance:

- 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*.

The word 'income' is defined in section 1 of the Act as the amount remaining of 'gross income' after the deduction of exempt income. Section 24C will, therefore, only be applicable if the taxpayer has already included in the calculation of his taxable income an amount received that meets the definition of 'gross income', as provided in section 1, and provided that this amount is not exempt income in terms of the Act.

The meaning of the words 'received by or accrued to' has been determined in case law. The current legal position indicates that 'received by' means the taxpayer's intention was to receive an amount for his own benefit (Stiglingh *et al.*, 2014:21). 'Accrued to' means that the taxpayer must be entitled to an amount (*Commissioner of Inland Revenue v People's Stores (Walvis Bay) (Pty) Ltd*, 52 SATC 9).

A 'contract' can be defined as an agreement which creates an obligation between the parties of the agreement (Sharrock, 2007:3). Although a contract must exist before section 24C will apply, the form and the nature of the contract in terms of which the income was received, are immaterial (Davis, Olivier & Urquhart, 2013:24C-2). The contract is discussed in further detail in chapter 3.

- The Commissioner is satisfied that *such amount will be utilised* in whole or in part to finance future expenditure.

The phrase 'such amount' refers to the income received by or accrued to the taxpayer from the contract. The taxpayer must utilise, in whole or in part, this income to finance the future expenditure. A definite connection must accordingly exist between the *income* and the *future expenditure* that will be incurred by the taxpayer. This matter is further discussed in 2.4.2.

- Such future expenditure *will be incurred* by the taxpayer *in the performance of his obligations under such contract*.

In section 24C the phrase 'will be incurred' is used in conjunction with the phrase 'in the performance of the taxpayer's obligations under the contract'. The meaning of the phrase 'will be incurred' is discussed in 2.7. The interplay between the incurral of the expenditure and the taxpayer's obligations to perform under the contract is discussed in chapter 3.

'Such contract' refers to the contract in terms of which the taxpayer received or accrued the income. The deduction for the section 24C allowance is, therefore, only available if the obligations to perform arise under the *same* contract as the contract from which the income, that must be utilised to finance the future expenditure, was received (Davis *et al.*, 2013:24C-2). This was demonstrated in *ITC 1667* which dealt with the section 24C deduction. The taxpayer's business was the selling, letting and repairing of office equipment. The section 24C allowance was not allowed because the income was not received in terms of the *same* contract which determined the obligation of the taxpayer to incur future expenditure. The taxpayer contested that, although he received the income under a *different* contract than the contract that obligated him to perform, the income *transaction* formed an integral part of the *scheme* that obligated him to incur expenditure in the performance of his obligation. The court held that the Legislator did not use the words *transaction* or *scheme* in section 24C, but that the operative concept was a 'contract'. Accordingly, it was held that the requirements of section 24C(2) had not been met since the income was not received from *the same* contract which determined the taxpayer's obligation to perform.

Section 24C(2) determines that the Commissioner has the discretion to decide whether the aforementioned requirements of section 24C(2) are met and whether he will allow the deduction. If the requirements are met, the allowance is an amount equal to so much of the future expenditure as the Commissioner may determine relates to the amount included in the taxpayer's income. This implies that the Commissioner also has the discretion to determine the amount of the deduction. Section 24C(2) also specifies that the amount of the deduction allowed may not exceed the amount included in the income of the taxpayer in terms of the contract.

### 2.3.3 Requirements of section 24C(3)

Section 24C(3) determines that:

- The amount of any allowance deducted under section 24C(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.

'Income' consists of gross income less exempt income. Specific inclusion (n) of the 'gross income' definition in section 1 of the Act includes in 'gross income' any amount which must be included in the taxpayer's income in terms of any other provision of the Act. Such amounts are deemed to be received by, or to have accrued to, the taxpayer. The amounts deducted in terms of section 24C(2) will, therefore, be deemed to be income received by the taxpayer in the subsequent year of assessment.

According to Clegg and Stretch (2011:par 11.11.7), the fact that the allowance is deemed to be income received by or accrued to the taxpayer in the next year of assessment does not mean that in the next year of assessment it will be income from a *contract*, as required by section 24C(2). It is, however, the practice of SARS to deal with this *deemed income* as if it were income from a *contract* (Clegg & Stretch, 2011:par 11.11.7). The effect is that in the following year of assessment, the taxpayer will have 'income' received by or accrued to him from a contract and the section 24C(2) allowance can again be utilised against this income, provided all the other requirements of section 24C are met.

### 2.4 Section 11(a)

Section 11 only permits for deductions if the taxpayer carries on any trade. Section 11(a) is the so-called general deduction formula. When an amount meets the requirements of this section, it will be allowed as a deduction in the calculation of taxable income, except if the deduction is prohibited by any other provision of the Act. In relation to section 24C, it is submitted that, if an amount will be deductible under section 11(a) in a subsequent year of assessment, and the amount meets the requirements of sections 24C(1) and (2) in the

current year, a deduction for the future expenditure will be allowed in terms of section 24C in the current year of assessment.

This assignment will not discuss all the requirements of section 11(a) in detail. The requirements of section 11(a) and section 24C are, however, listed and compared in Table 2.1. The similarities and differences between these sections are identified in 2.4.2. This serves to illustrate that the word ‘expenditure’ and the phrase ‘actually incurred’ used in section 11(a) can contribute to an understanding of the word ‘expenditure’ and the phrase ‘will be incurred’, as used in section 24C.

#### 2.4.1 Comparison between the requirements of section 11(a) and sections 24C(1) and (2)

**Table 2.1 A schematic comparison of the requirements of section 11(a) and sections 24C(1) and (2)**

Section 11(a)	Section 24C(2)
<ul style="list-style-type: none"> <li>For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person:</li> </ul>	<ul style="list-style-type: none"> <li>There shall be deducted in the determination of the taxpayer’s taxable income for such year such allowance (not exceeding the said amount) as the Commissioner may determine, in respect of so much of such future expenditure as in his opinion relates to the said amount: <i>(The ‘said amount’ refers to the income received by the taxpayer in terms of a contract.)</i></li> </ul>
<b>Requirements that must be met:</b>	
	<ul style="list-style-type: none"> <li>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</li> </ul>

	<ul style="list-style-type: none"> <li>the Commissioner is satisfied that such amount will be utilised in whole or in part to finance</li> </ul>
<ul style="list-style-type: none"> <li><u>expenditure and losses</u></li> </ul>	<ul style="list-style-type: none"> <li>future <u>expenditure</u></li> </ul>
<ul style="list-style-type: none"> <li><u>actually incurred</u></li> </ul>	<ul style="list-style-type: none"> <li>which <u>will be incurred</u></li> </ul>
<ul style="list-style-type: none"> <li><u>in the production of income</u></li> </ul>	<ul style="list-style-type: none"> <li>by the taxpayer <u>in the performance of his obligations under such contract.</u></li> </ul>
<b>Section 24C(1)</b>	
<ul style="list-style-type: none"> <li><u>incurred during the year of assessment</u> <i>Concentra (Pty) Ltd v Commissioner for Inland Revenue</i> 12 SATC 95 (‘<i>Concentra (Pty) Ltd v CIR</i>’)</li> </ul>	<ul style="list-style-type: none"> <li><u>Future expenditure</u> (as defined in sections 24C(1)(a) and (b) <u>in relation to any year of assessment</u> means an amount of expenditure which the Commissioner is satisfied <u>will be incurred after the end of such year.</u></li> </ul>
<ul style="list-style-type: none"> <li>provided the expenditure and losses are not of a capital nature.</li> </ul>	

#### 2.4.2 Similarities and differences between the requirements of section 11(a) and sections 24C(1) and (2)

The comparison in Table 2.1 reveals the following similarities and differences between the requirements of section 11(a) and sections 24C(1) and (2):

- Section 11(a) uses the phrase ‘expenditure and losses’. Sections 24C(1) and (2) use the phrase ‘future expenditure’ and no reference is made to the word *losses*. The word *expenditure* is, therefore, used in both sections. The meaning of the phrase ‘expenditure and losses’ has been defined in case law. The meaning of the word ‘expenditure’, as used in section 24C, is discussed in 2.5 with reference to the meaning of the phrase ‘expenditure and losses’, as used in section 11(a).
- Section 11(a) refers to expenditure and losses ‘actually incurred’. Section 24C(1) and section 24C(2) refer to expenditure that ‘will be incurred’. Both section 11(a) and sections 24C(1) and (2), therefore, refer to the *incurral* of expenditure. The meaning of the phrase ‘actually incurred’ and the word ‘incurred’ have been defined in case

law and this is discussed in 2.6 to form a basis for the interpretation of the phrase 'will be incurred', as used in section 24C.

- Section 11(a) refers to expenditure and losses actually incurred 'in the production of income'. Section 24C(2) refers to future expenditure which will be incurred by the taxpayer 'in the performance of his obligations under a contract'. Both these sections, therefore, qualify the *incurral* of the expenditure in relation to a specific requirement. The qualification for section 11(a), namely that expenditure must be incurred *in the production of income*, was addressed in *PE Electric Tramway Co Ltd v CIR*. It was determined that the action that gives rise to the expenditure must be *closely connected* with the income-earning activities.

In section 24C(2) the phrase *will be incurred* forms the connection between the future expenditure and the taxpayer's performance of his obligations under a contract. The words 'will' and 'shall' are used interchangeably in the English language (*The Oxford English Dictionary* ('OED'), 2014:shall). In addition, the word 'shall' is often used as an equivalent to 'must' (Clegg & Stretch, 2011:par 2.9). It is, therefore, submitted that the word 'will', as part of the phrase 'will be incurred', indicates that future expenditure *must* be incurred by the taxpayer in the performance of his obligations under a contract. A *definite connection* is, therefore, created between the incurral of the future expenditure and the taxpayer's performance of his obligations under a contract. The qualification for section 24C, namely that the future expenditure will be incurred by the taxpayer *in the performance of his obligations under a contract*, will be addressed in further detail in chapter 3.

- In *Concentra (Pty) Ltd v CIR* it was determined that the expenditure and losses actually incurred in terms of section 11(a) are restricted to those actually incurred *during the year of assessment*. Section 11(a), therefore, limits the incurral of the expenditure and losses to the *current* year of assessment. Section 24C(1) refers to the incurral of the expenditure in a *subsequent year of assessment*. Therefore, although both the *deductions* under section 11(a) and section 24C are allowed in the current year of assessment, the expenditure is *incurred* in *different years of assessment*. It is, therefore, firstly important to determine whether there is, or will be, an incurral of expenditure and then to establish in which year of assessment the incurral takes effect. The indicators that serve to demonstrate that expenditure is

*incurred* are discussed in 2.6 and the meaning of 'will be incurred' is addressed in 2.7.

To summarise, the meaning of the phrases 'expenditure and losses' and 'actually incurred', as used in section 11(a), has been determined in authoritative case law. An understanding of the meaning of these phrases, as determined by the courts, and with specific reference to the words 'expenditure' and 'incurred', as used in section 11(a), can provide guidance as to the meaning of the word 'expenditure' and the phrase 'will be incurred', as used in section 24C.

### **2.4.3 The interplay between section 11(a) and section 24C**

The interplay between section 11(a) and section 24C can be explained as follows:

A taxpayer receives income under a contract during the current year of assessment. The taxpayer will incur expenditure in the performance of his obligation under the contract. If the expenditure under the contract is actually incurred in the *current* year of assessment and the requirements of section 11(a) are met, the expenditure will be deductible in terms of section 11(a) in the *current* year of assessment. If the expenditure in terms of the contract is not yet *actually incurred*, as required by section 11(a), it will not be deductible under section 11(a). However, if the taxpayer can prove that the expenditure *will be incurred in a subsequent year of assessment* and all the other requirements of section 24C are met, the Commissioner will allow the section 24C allowance in the *current* year of assessment.

It is important to note that, when discussing section 11(a), there are deductions that are specifically prohibited by section 23 of the Act. One of these prohibitions is section 23(e), which states that no deduction shall be allowed where income is carried to any reserve fund or capitalised in any way. This provision will prohibit a deduction of contingent or anticipated liabilities which have not actually been incurred (Meyerowitz, 2008:11-6). There are, however, specific exceptions to section 23(e) and one of these exceptions is provided by section 24C, which permits for the deduction of future expenditure on contracts (De Koker & Williams, 2011:par 7.47). If the requirements of section 24C are met, the prohibition in terms of section 23(e) will not apply. The interplay between section 24C and section 23(e) is discussed further in chapter 4.2.2.2.

## 2.5 The meaning of the word ‘expenditure’, as used in section 24C

As mentioned in the discussion of the requirements of section 24C (2.3.1), the meaning of the word ‘expenditure’ is not defined in the Act. The meaning of the word ‘expenditure’ with relation to section 24C was, however, addressed in *ITC 1739*. The taxpayer was a manufacturer of certain products (held as trading stock) which were sold with a manufacturer’s warranty to various motor assembly plants. The motor assembly plants are referred to as original equipment manufacturers (‘OEM’). The OEM, in turn, supplied completed vehicles to dealers and distributors. In the event of a warranty claim, the OEM would claim the parts necessary for the repair of the vehicle from the taxpayer. The taxpayer wanted to utilise the section 24C allowance. He argued that, when determining the price for his products he, *inter alia*, considers the terms of the manufacturer’s warranty since, in the event of a claim, he will incur a cost to honour his obligation under the warranty contract. The Commissioner disallowed the taxpayer’s claim on the basis that it was a warranty claim and, therefore, a *contingent liability*<sup>2</sup>. The taxpayer appealed to the court. The court did not address the matter of a contingent liability, but disallowed the appeal based on the fact that the taxpayer incurred a *loss*, as opposed to *expenditure*. The court held that, in honouring his obligation, the taxpayer incurred a *loss* when he supplied parts from his trading stock to replace the defective parts.

An evaluative commentary on *ITC 1739* was subsequently given by JutaLaw (*Case no. 10723*). It states that the cost incurred by the taxpayer to manufacture the trading stock represents *expenditure*. It is, however, effectively not yet deducted for tax purposes at the end of the year of assessment since section 22(1) provides that the value of closing trading stock held at year end must be included in the calculation of the taxable income of the taxpayer. According to JutaLaw, based on the aforementioned, there is scope for a view that when the manufacturer uses this trading stock to meet his warranty obligation in a subsequent year of assessment, he will incur ‘future expenditure’<sup>3</sup>.

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<sup>2</sup> The Commissioner’s argument that a warranty contract represents a *contingent liability* will be discussed in chapter 4.

<sup>3</sup> Whether *closing stock* on hand can be included as ‘future expenditure’ in terms of section 24C will be discussed in further detail in chapter 5.4.

There are, accordingly, different opinions as to what comprises future *expenditure*. It is submitted that the ruling in *ITC 1739* implies that the word 'expenditure' in section 24C does not include a reference to *losses* and section 24C, therefore, excludes a deduction for future losses. JutaLaw is, however, of the opinion that, because the taxpayer incurs costs to manufacture the trading stock, it is *expenditure* and should, therefore, be included in the meaning of the word 'expenditure', as used in section 24C.

It follows that there are two questions which must be addressed, namely: What is the meaning of the word 'expenditure' and does the word 'expenditure', as used in section 24C, include a reference to a *loss*? These two questions are now discussed with reference to case law and the *Explanatory Memorandum* on section 24C.

### **2.5.1 The meaning of the word 'expenditure' with reference to case law**

The meaning of 'expenditure' was determined in *Commissioner for South African Revenue Service v Labat Africa Ltd* 74 SATC 1 ('*C:SARS v Labat Africa Ltd*'). In this case, the court had to decide whether the issue of a company's own shares in consideration for the acquisition of a trademark constituted 'expenditure actually incurred', as required in section 11(gA) of the Act. Harms AP held that:

The term 'expenditure' is not defined in the Act and since it is an ordinary English word and, unless the 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. (6) (own emphasis)

Thus, according to this judgement by Harms AP, the word 'expenditure' refers to an amount of money spent or the disbursement of other assets of the taxpayer with a monetary value. Meyerowitz (2008: 11-13) also confirms that expenditure may take on any form that has a value in monetary terms and can include cash, but is not limited to cash.

The meaning of the word 'expenditure' was also discussed in *Joffe & Co (Pty) Ltd v CIR*. The taxpayer was an engineering company. The negligence of the company caused the death of an employee which led to the incurring of legal expenditure and the company had to pay damage compensation. The question before the court was whether this expenditure could be allowed as a deduction under section 11(2)(a) of the Income Tax Act No 31 of 1941. The context of section 11(2)(a) of the Income Tax Act No. 31 of 1941 was almost identical to the context of section 11(a) in the Act (Stiglingh *et al.*, 2014:139). In section 11(a), the word 'expenditure' is used in conjunction with the word 'losses'. The company contested that the damage compensation payments and the legal cost were either *expenditure* or *losses*. Watermeyer CJ held that the word 'loss' has several meanings and that its meaning in section 11(2)(a) was somewhat obscure. Watermeyer CJ stated that, in relation to trading operations, expenditure usually means the *voluntary payment of money*, whereas losses is sometimes used to signify a deprivation suffered by the loser, usually an *involuntary deprivation*. Watermeyer CJ continued with an explanation of his argument:

[W]hen trading operations cause damage to third parties and this damage has to be made good, then the payment which is made in satisfaction of such damage may properly be called a loss, but when the payment has been made then it can also properly be called an expenditure. (360)

Watermeyer CJ highlighted the voluntary nature of expenditure and the involuntary nature of losses, and, in the case of payments for damages, he equated the words 'loss' and 'expenditure'.

According to Haupt (2012:118), it is not certain whether there actually is a difference between these words. Haupt also stated, with reference to section 11(a), that if a distinction does exist, it is not an important problem when determining whether an amount is deductible. This is because both the 'expenditure' and 'loss' are deductible under section 11(a), provided the other requirements of section 11(a) are met. It, therefore, appears that for section 11(a) the difference between the words 'expenditure' and 'losses' is of no particular importance.

Section 24C, however, only refers to 'expenditure' and does not specifically include 'losses'. According to Davis *et al.* (2013:11(a)-6) the rules of interpretation of statutes stipulate that each word in a statute should be ascribed a specific meaning and that the

word 'expenditure' should, therefore, mean something different compared to the word 'losses'. For the purpose of section 24C, a distinction between 'expenditure' and 'losses' is, therefore, important since only the word 'expenditure' is used in this section.

The statement of Watermeyer CJ, that in relation to trading operations, expenditure usually means the *voluntary payment of money*, can assist with the interpretation of the meaning of 'expenditure', as used in section 24C. According to the OED (2014:voluntary), the word *voluntary* refers to:

An action performed or done of one's own free will, impulse, or choice; not constrained, prompted, or suggested by another. Sometimes denoting 'left to choice', 'not required or demanded of one'.

In light of the aforementioned it is, therefore, submitted that, when interpreting section 24C, if a taxpayer becomes a party to a contract *by his own choice* and he agrees to spend money or to disburse some of his assets in the performance of his obligations under the contract, it will be regarded as 'expenditure'.

### **2.5.2 The meaning of the word 'expenditure' with reference to the *Explanatory Memorandum* on section 24C**

According to the *Explanatory Memorandum*, section 24C empowers 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*. The *Explanatory Memorandum* does not provide any additional explanation for the meaning of the word 'expenditure' and does not limit the use of the word 'expenditure' in any way. Therefore, it is clear that the *Explanatory Memorandum* does not expand on the understanding of the meaning of the word 'expenditure', as used in section 24C.

### **2.5.3 Conclusion on the meaning of the word 'expenditure', as used in section 24C**

Section 24C only uses the word 'expenditure' and, accordingly, excludes the word 'loss'. Section 24C(1) determines that the 'expenditure' must be deductible in terms of a provision in the Act in a subsequent year of assessment or that it must be in respect of the acquisition of any asset for which any deduction will be admissible under the provisions of

the Act. It follows that if the amount under contention ascribes to the meaning of *expenditure*, as defined by the courts, and all the other requirements in terms of section 24C are met, it is deductible under section 24C.

There are two matters regarding the meaning of the word *expenditure*, as used in section 24C, which require conclusion:

- What is the meaning of the word ‘*expenditure*’?

It is submitted that the meaning of the word ‘*expenditure*’ in section 24C should be determined with reference to its ordinary meaning, as held by Harms AP in *C:SARS v Labat Africa Ltd*, as the amount of money spent, including the disbursement of other assets with a monetary value.

It follows, with reference to the argument by Watermeyer CJ in *Joffe & Co (Pty) Ltd v CIR*, that the word ‘*expenditure*’, as used in section 24C, will include, *inter alia*, a voluntary payment of money by the taxpayer *and* the voluntary disbursement of the taxpayer’s assets. It is submitted that if a taxpayer *by his own choice* agrees contractually to the incurral of *expenditure* in terms of a contract from which he receives income, the incurral of such amounts will constitute voluntary payments and will, therefore, qualify as ‘*expenditure*’.

Following the aforementioned and in the light of JutaLaw’s commentary on *ITC 1739* it is further submitted that if a taxpayer will utilise his trading stock in the performance of his obligation under the contract, the trading stock will be ‘*expenditure*’, as it forms part of the taxpayer’s assets. However, before the section 24C allowance will be allowed, all the requirements of section 24C must be met, which *inter alia* includes that it must be *future* *expenditure*. This will be discussed further in chapter 5.4.

- Does the word ‘*expenditure*’, as used in section 24C, include a reference to a loss?

It is submitted with reference to the argument by Watermeyer CJ in *Joffe & Co (Pty) Ltd v CIR*, that, if a *loss* can be equated with the meaning of the word ‘*expenditure*’, then the *loss* will be deductible as ‘*expenditure*’, in terms of section 24C, provided all other requirements are met.

If a loss cannot be equated with the meaning of the word 'expenditure', uncertainty remains as to whether it is deductible in terms of section 24C<sup>4</sup>. It is, however, submitted that the fact that the text of section 24C does not include the word 'loss' might be an indication that, if a loss cannot be equated with the meaning of the word 'expenditure', it will not be deductible in terms of section 24C.

## 2.6 The meaning of 'actually incurred' and 'incurred'

Both section 24C and section 11(a) contain the word 'incurred'. Section 11(a) provides for a deduction of expenditure and losses *actually incurred* in the production of income, provided it is not capital in nature. Although the meaning of the phrase 'actually incurred' in section 11(a) is not defined in the Act, the meaning of 'actually incurred' and 'incurred' has been determined by case law. The meaning of 'actually incurred' and 'incurred', as used in section 11(a), can, therefore, form a basis for determining the meaning of the phrase 'will be incurred', as used in section 24C.

It is important to note that, when discussing section 11(a), it is accepted that, although the section does not state that the expenditure and losses should be actually incurred *during the year of assessment*, it is a requirement implicit in the Act itself. *Actually incurred* should, therefore, be read in conjunction with *during the year of assessment*.

The meaning of *actually incurred* is discussed with reference to:

- The terminology used in case law.
- The difference between *actually incurred* and *incurred*.
- Case law on the meaning of actually incurred and incurred.

### 2.6.1 Terminology used in case law

In determining the meaning of actually incurred, the courts have used several descriptive words to explain their interpretation of 'actually incurred'. These cases are discussed in 2.6.3. The following words and phrases have, *inter alia*, been used by the courts in case law concerning the meaning of *actually incurred*:

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<sup>4</sup> No further research will be done on this matter in this assignment and it is, therefore, an aspect that remains to be decided by authoritative case law.

- Liability / liability to pay / legally liable to pay / definite and absolute liability / absolute and unqualified legal liability
- Contingent liability
- Obligation / obligation to pay / unconditional legal obligation
- Unconditional legal liability

Although it might appear that there are different interpretations to the meaning of *actually incurred*, many of these descriptive words are substitutes for each other. The correlation between the following words is briefly discussed with reference to their meaning in the OED (2014) and *Osborn's Concise Law Dictionary* (Bird, 1983):

- Liability, liable and obligation
- Contingent, conditional and condition
- Unconditional obligation and contingent liability.

#### **Liability (noun)**

- The condition of being *liable* or answerable by law or equity (OED, 2014:liability - *Law*). (own emphasis)
- Subjection to legal *obligation*; or the *obligation itself*. He who commits a wrong or breaks a contract or trust is said to be liable or responsible for it. Liability is civil or criminal according to whether it is enforced by the civil or criminal courts. (Bird, 1983:liability). (own emphasis)

#### **Liable (adjective)**

- Bound or *obliged* by law or equity, or in accordance with a rule or convention; answerable; legally subject or amenable *to* (OED, 2014:liable - *Law*). (own emphasis)
- The one who incurs legal liability (Bird, 1983:liable).

#### **Obligation (noun)**

- A binding agreement committing a person to a payment or other action; the document containing such an agreement; a written contract or bond. Also: the right created or *liability incurred* by such an agreement, document, or bond; the

duty of a borrower to repay a loan. Now chiefly superseded by contract (OED, 2014:obligation - *Law and Finance*). (own emphasis)

- A duty: the bond of legal necessity which binds together two or more determinate individuals. It is limited to legal duties arising out of a special personal relationship existing between them, whether by reason of a contract or a tort, or otherwise, e.g. debtor and creditor. See *LIABILITY* (Bird, 1983:obligation). (own emphasis)

From the above definitions of the nouns 'liability' and 'obligation', it is clear that they can be used as substitutes for each other since an 'obligation' refers to a liability incurred (OED, 2014:obligation) and a 'liability' refers to an obligation itself (Bird, 1983:liability). This is also confirmed in *Ackermans Ltd v C:SARS*, where it was held that:

'[E]xpenditure incurred' means the undertaking of an *obligation to pay* or (which amounts to the same thing) the *actual incurring of a liability*. (5) (own emphasis)

### **Contingent (adjective)**

- Dependent on a pre-contemplated probability; provisionally liable to exist or take effect; *conditional; not absolute* (OED, 2014:contingent - *Law*). (own emphasis)
- That which waits or depends on the happening of an event (Bird, 1983:contingent).
- A *contingent liability* is a future *unascertained obligation* (Bird, 1983:liability). (own emphasis)

### **Conditional (adjective)**

- Subject to, depending on, or limited by, one or more conditions; *not absolute*; made or granted on certain terms or stipulations (OED, 2014:conditional). (own emphasis)

### **Condition (noun)**

- A provision which makes the existence of a right dependent on the happening of an event; the right is then *conditional, as opposed to an absolute right*. A true condition is where the event on which the existence of the right depends is *future and uncertain* (Bird, 1983:condition). (own emphasis)

From the above definitions of the words ‘contingent’, ‘conditional’ and ‘condition’ it is clear that the adjectives ‘contingent’ and ‘conditional’ can be used as substitutes for each other as ‘contingent’ is also described as conditional or not absolute (OED, 2014:contingent) or dependent upon the happening of an event (Bird, 1983:contingent). ‘Conditional’ is further also described as not absolute (OED, 2014:conditional) and dependent upon the happening of a future and uncertain event (Bird, 1983:condition).

### **Unconditional obligation and contingent liability**

According to *The Opposite Dictionary* (2014), the opposite word for ‘unconditional’ is conditional. Since ‘conditional’ and ‘contingent’ can be used as substitutes for each other, they are both opposites for ‘unconditional’. ‘Obligation’ and ‘liability’ are also substitutes for each other. The opposite of an ‘unconditional obligation’ can, therefore, be called a ‘contingent liability’<sup>5</sup>. A contingent liability is a future unascertained obligation (Bird, 1983:liability).

In summary, it is submitted that, in the context of section 11(a) and with reference to the meaning of *actually incurred*,

- liability and obligation are substitutes for each other; and
- contingent and conditional are substitutes for each other; and
- contingent and conditional are the opposite of unconditional; and
- an unconditional obligation is the opposite of a contingent liability.

This terminology will also be used in chapter 3, where the taxpayer’s obligation to perform in terms of a contract is discussed.

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<sup>5</sup> The phrase *contingent liability* is used in Income Tax cases on section 24C. Since case law on the meaning of ‘actually incurred’ in section 11(a) is used to determine the meaning of ‘will be incurred’ in section 24C, the correlation between these phrases, as used in case law on section 11(a) and section 24C respectively, is established.

## 2.6.2 ‘Actually incurred’ versus ‘incurred’

Section 11(a) refers to ‘actually incurred’ and not only ‘incurred’. According to Davis *et al.* (2013:11(a)-11), it is difficult to understand the difference between when expenditure is *incurred* and when it is *actually incurred*. It is, however, a rule of interpretation that every word in a statute should be given a meaning and should not be regarded as superfluous, void or insignificant (Kellaway, 1995:92).

According to *The Oxford English Dictionary* (2014) the adverb *actually* means:

In action; in fact, in reality, really. Opposed to: *possibly, potentially, theoretically*.

If these words are used in section 11(a) as a substitute for *actually*, section 11(a) would read as follows:

- Expenditure and losses *really / in fact / in reality* incurred during the year of assessment.

In *Commissioner for Inland Revenue v Golden Dumps (Pty) Ltd* 55 SATC 198 (‘*CIR v Golden Dumps (Pty) Ltd*’) a former employee of the taxpayer brought a claim against the taxpayer for the delivery of shares as compensation for work done by the employee in terms of a contract. At the end of the year of assessment the claim was still in dispute. The court held that where there is a *dispute* regarding a liability, the *liability is contingent* and the expenditure and losses are, therefore, not deductible in the year of assessment.

In considering whether the expenditure was actually incurred, Nicholas AJA, *inter alia*, held that it cannot be suggested that the Legislator used the word *actually* through inadvertence or error. On p 205 Nicholas AJA referred to an unreported judgement by Watermeyer, then president of the Special Court for Income Tax Appeals, in the Jacobsohn’s case (circa 1923), where it was held that:

The phrase ‘actually incurred’ here in our opinion means no more than that the loss must be an *ascertained* loss in the year of assessment: the word ‘*actually*’ *does not push the meaning of ‘incurred’* further so as to give it the sense ‘realised in cash’ as contended by the Commissioner. (own emphasis)

It, therefore, seems that the word ‘actually’ ascribes *certainty* to the fact that the expenditure has been incurred during the year of assessment, as opposed to it only being *possibly incurred*.

### 2.6.3 Case law on the meaning of ‘actually incurred’ and ‘incurred’

In this section the case law in which the meanings of *actually incurred* and *incurred* were addressed will be discussed in chronological order, as some of the latter court cases refer to previous judgements to support their arguments. Some of the court cases also discuss indicators that will serve to demonstrate that the expenditure is not yet actually incurred.

- *Port Elizabeth Electric Tramway Co Ltd v CIR* dealt with the deductibility of damage compensation in terms of section 11(2) of the Income Tax Act 40 of 1925, which was a similar provision to section 11(a) of the Act. Watermeyer AJP held that expenditure ‘actually incurred’ cannot mean *actually paid*. He held that, as long as there is a *liability to pay*, the expenditure has been actually incurred and the expenditure is deductible.
- *ITC 542* 13 SATC 116 (*‘ITC 542’*) dealt with the deductibility of interest on loans by directors in terms of section 11(2) of the Income Tax Act 31 of 1941. In this case, Nathan K.C. stated that it was not necessary to further explore the meaning of ‘actually incurred’. He held that ‘incurred’ means either ‘paid’ or ‘become liable for’. In *ITC 542* reference was also made to a previous unreported case (*Case 1877*) where it was held that the words ‘expenditure actually incurred’ seems to mean: (1) moneys *actually paid out*, or (2) moneys which a trader is *legally liable to pay*.
- *Caltex Oil (SA) Ltd v Secretary for Inland Revenue* 37 SATC 1 (*‘Caltex Oil (SA) Ltd v SIR’*) was a court case on the deductibility of expenditure in terms of section 11(a). In coming to his conclusion, Botha JA referred to the judgement in *Port Elizabeth Electric Tramway Co Ltd v CIR* and *ITC 542* and stated that ‘actually incurred’ referred to the year in which a *liability* for the expenditure is incurred, *whether the liability is discharged during that year or not*.
- In *Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste* 48 SATC 55 (*‘Nasionale Pers Bpk v KBI’*) the company wanted to deduct a provision for the future

payment of bonuses, in terms of section 11(a). According to the contracts with each employee, the holiday bonuses were only payable to employees who were in the company's employment on 31 October each year. The company's year of assessment ended on 31 March and the company wanted to deduct a *pro rata* portion of the provision for bonuses in the particular year of assessment.

In considering whether the expenditure was 'actually incurred', Hoexter AR held that *possible* future expenditure that is only *deemed probable* will not be deductible in terms of section 11(a). He held that for expenditure to be 'actually incurred', there must be a *definite and absolute liability*.

Hoexter AR also referred to *ITC 969 24 SATC 777* ('*ITC 969*') where it was held, with reference to the deductibility of expenditure in a provision similar to section 11(a), that the appellant company could not claim the deduction. This was because the appellant company could not prove that it had completely subjected itself to a liability and, therefore, the taxpayer had not incurred an *absolute and unqualified legal liability*. The expenditure was, therefore, not actually incurred.

- *Edgars Stores Ltd v Commissioner for Inland Revenue 50 SATC 81* (*Edgars Stores Ltd v CIR*) dealt with the deductibility of rental payments for the lease of premises in terms of section 11(a). The lease agreement provided for *basic rental* and *turnover rental*. The amount of turnover rental was based upon the lessee's turnover over a twelve-month period, running from the date of the commencement of the lease. Consequently, the turnover rental was usually only ascertainable subsequent to the concluding date of the lessee's year of assessment. Corbett JA considered the meaning of *actually incurred* and held that:

[O]nly expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has *incurred an unconditional legal obligation* during the year of assessment in question may be deducted in terms of section 11(a) from income returned for that year.

[I]f the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year

of assessment, it is deductible only in the latter year of assessment (the other requirements of deductibility being satisfied).(90)

- In *CIR v Golden Dumps (Pty) Ltd* the court had to decide whether a liability that is in dispute at the end of the year of assessment is expenditure 'actually incurred' in terms of section 11(a). In considering whether the expenditure was actually incurred, Nicholas AJA referred, on p 205, to an Australian High Court case where it was held that:

'[I]ncurred' does not mean only defrayed, discharged or borne, but rather it includes encountered, run into or fallen upon [... incurred] does not include a loss or expenditure which is no more than *impending, threatened or expected*. (own emphasis)

The court held that where there is a *dispute* regarding a liability, the *liability is contingent* and the expenditure and losses are, therefore, not actually incurred and not deductible in the year of assessment.

- In *Ackermans Ltd v C: SARS*, the company sold his business as a going concern. As part of the purchase price, the purchaser also took over the liabilities, which included contingent liabilities. The purchaser, therefore, paid for the net asset value of the business (the assets less the liabilities). The company contested that, by foregoing a portion of the assets' purchase price, he incurred expenditure to free itself from the contingent liabilities. The company wanted to deduct the calculated value of the contingent liabilities as 'expenditure actually incurred' in terms of section 11(a). The court disallowed the deduction, as the company did not incur a liability in terms of the sales agreement.

In coming to the conclusion Cloete JA held that:

'[E]xpenditure incurred' means the undertaking of an *obligation to pay* or (which amounts to the same thing) the *actual incurring of a liability*. (5)

## 2.6.4 Summary of case law on the meaning of ‘actually incurred’ and ‘incurred’

**Table 2.2 Requirements for ‘actually incurred’ in terms of case law**

Conclusion from case law	Reference
<ul style="list-style-type: none"> <li>• There is a <i>liability to pay</i> for expenditure;</li> <li>• Actually incurred cannot mean actually paid.</li> </ul>	<i>Port Elizabeth Electric Tramway Co Ltd v CIR</i>
<ul style="list-style-type: none"> <li>• Money is actually paid out; or</li> <li>• A taxpayer is <i>legally liable to pay</i> money.</li> </ul>	<i>ITC 542</i> (by referring to unreported case 1877)
<ul style="list-style-type: none"> <li>• Actually incurred refers to the year in which a <i>liability</i> for the expenditure is incurred, <i>whether the liability is discharged during that year or not.</i></li> </ul>	<i>Caltex Oil (SA) Ltd v SIR</i>
<ul style="list-style-type: none"> <li>• There is a <i>definite and absolute liability</i>;</li> <li>• There is an <i>absolute and unqualified legal liability</i>.</li> </ul>	<i>Nasionale Pers Bpk v KBI</i> <i>Nasionale Pers Bpk v KBI</i> (by referring to <i>ITC 969</i> )
<ul style="list-style-type: none"> <li>• Actually incurred <i>refers to</i> expenditure in respect of which the taxpayer has <i>incurred an unconditional legal obligation</i> during the year of assessment.</li> </ul>	<i>Edgars Stores Ltd v CIR</i>
<ul style="list-style-type: none"> <li>• There is an undertaking of an <i>obligation to pay</i>; or</li> <li>• There is an <i>actual incurral of a liability</i>.</li> </ul>	<i>Ackermans Ltd v C: SARS</i>

In the above mentioned judgements on the meaning of ‘actually incurred’, certain aspects were highlighted by the courts that indicate that expenditure is not yet ‘actually incurred’.

**Table 2.3 Indicators that serve to demonstrate that expenditure is not yet ‘actually incurred’ during the year of assessment in terms of section 11(a)**

Conclusion from case law	Reference
<ul style="list-style-type: none"> <li>• There is only <i>possible future expenditure</i> that is only <i>deemed probable</i>.</li> </ul>	<i>Nasionale Pers Bpk v KBI</i>
<ul style="list-style-type: none"> <li>• There is a <i>dispute</i> regarding a liability. A dispute would indicate that the <i>liability is contingent</i>.</li> <li>• There is loss or expenditure which is no more than <i>impending, threatened or expected</i>.</li> </ul>	<i>CIR v Golden Dumps (Pty) Ltd</i> <i>CIR v Golden Dumps (Pty) Ltd</i> (by referring to an Australian High Court case)
<ul style="list-style-type: none"> <li>• The taxpayer has a <i>contingent liability</i>.</li> </ul>	<i>Ackermans Ltd v C: SARS</i>

‘Incurred’, therefore, indicates that the taxpayer has, during the year of assessment, incurred *an unconditional obligation to pay for expenditure*. The word ‘unconditional’ implies that there are no conditions or future uncertain events that will influence the obligation to pay. It also implies that the obligation is not contingent. The word ‘actually’ confirms that the obligation to pay is not only *possible or probable* at year end, but the taxpayer has *really or in fact* incurred the obligation to pay during the year of assessment. Meyerowitz (2008:11-15) confirmed this and stated that *however likely* it is that the taxpayer will be called upon to pay for a contingent liability, if there is no *absolute liability*, the expenditure will *not be actually incurred*.

The aforementioned meaning of the word ‘incurred’ will be used to determine the meaning of ‘will be incurred’, as used in section 24C(1) and section 24C(2).

## **2.7 The meaning of ‘will be incurred’**

Section 24C(1) requires that the Commissioner must be satisfied that the amount of expenditure *will be incurred after the end of the year of assessment*; and

Section 24C(2) requires that the Commissioner must be satisfied that the future expenditure *will be incurred by the taxpayer in the performance of his obligations under such contract*.

The phrase ‘will be incurred’, as used in section 24C, is not defined in the Act. The meaning of ‘will be incurred’ is discussed with reference to:

- The ordinary English meaning,
- The *Explanatory Memorandum* on section 24C, and
- The meaning of the word ‘incurred’, as used in section 11(a).

### **2.7.1 The meaning of the phrase ‘will be incurred’ with reference to its ordinary English meaning**

In terms of the rules of language, ‘will’ is an auxiliary verb, also known as a *helping verb* that refers, *inter alia*, to the *future*. The auxiliary verb ‘will’ is used to make predictions or

simple statements of fact about the future (*A Guide to Learning English*, 2011:Future Tense).

The word 'be' is described in the OED (2014:be) as:

*To come into existence*, come about, happen, occur, take place, be carried out or done; to take its due course, have the appointed period of time. (own emphasis)

The OED (2014:will-be) describes the phrase 'will-be' as:

A person or thing that will be *but is not yet*. (own emphasis)

The word 'incur' is described in the OED (2014:incur) as:

To run or fall into (some consequence, usually undesirable or injurious); to *become through one's own action liable or subject to*; to bring upon oneself. (own emphasis)

The meaning of *will be incurred* can, according to its ordinary English meaning, be summarised as follows:

- In the future (will), a liability (incurred), will come into existence (be);
- The liability is not yet in existence.

### **2.7.2 The meaning of the phrase 'will be incurred' with reference to the *Explanatory Memorandum* on section 24C**

The *Explanatory Memorandum* refers to a situation where a taxpayer is taxed on large advance payments which are *not matched by deductible expenditure* in the same year of assessment. From the *Explanatory Memorandum*, it seems that the purpose of section 24C is to create an allowance that will *match the income* from the contract with the future deductible expenditure. It is clear that this allowance represents the expenditure that will be *deductible* in the calculation of taxable income in a subsequent year of assessment.

With reference to the *Explanatory Memorandum*, it is concluded that the phrase 'will be incurred' refers to the incurral of an amount of expenditure that *will be deductible in the calculation of the taxpayer's taxable income* in a subsequent year of assessment. The phrase 'will be incurred', therefore, speaks of the deductibility of the expenditure in a year of assessment subsequent to the year in which the income in terms of the contract is received or accrues.

### 2.7.3 'Will be incurred': Section 24C

With reference to the meaning of the word 'incurred', as set out in 2.6, the ordinary English meaning of the phrase 'will be incurred' and the *Explanatory Memorandum*, it is submitted that the meaning of the phrase 'will be incurred' in section 24C(1) implies that:

- in the future (will)
- an unconditional obligation to pay for expenditure (incurred)
- will come into existence (be).
- This unconditional obligation to pay for expenditure does not exist at year-end, but it will exist in the future. Section 24C(1) specifies the future as a subsequent year of assessment.
- This unconditional obligation to pay for expenditure will represent an amount that is deductible in the calculation of taxable income.

Thus, the taxpayer is not required to have an unconditional obligation to pay for expenditure at the end of the year of assessment. He must, however, satisfy the Commissioner that an unconditional obligation to pay for expenditure will come into existence in a subsequent year of assessment, and that it will be an amount that is deductible in the calculation of taxable income. As the taxpayer has not yet incurred this unconditional obligation to pay for expenditure during the current year of assessment, the question that arises is: What will serve to demonstrate that the expenditure *will be incurred*? This question can be stated differently: What will indicate that the taxpayer *will have* an unconditional obligation to pay for expenditure in a subsequent year of assessment?

It is argued that the answer to this question lies in section 24C(2). Section 24C(2) also uses the phrase 'will be incurred'. This section, however, provides for an additional

requirement for 'will be incurred', namely, the future expenditure will be incurred *by the taxpayer in the performance of his obligations under a contract*.

To summarise, it is submitted that the phrase 'will be incurred', as used in section 24C, implies that the taxpayer will have an unconditional obligation to pay for expenditure in a subsequent year of assessment. This obligation to pay for expenditure must arise from the taxpayer's obligations to perform under the contract. This is in agreement with the argument in 2.4.2, where it was shown that there must be a *definite connection* between the contract that determines the taxpayer's obligation to perform and the incurral of the future expenditure. Chapter 3 and 4 will discuss indicators that will serve to demonstrate whether future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract.

## **2.8 Conclusion**

Chapter 2 determined that the word 'future' refers to the fact the expenditure must be incurred in a year of assessment subsequent to the year in which the income in terms of the contract is received or accrues. The word 'expenditure' means the amount of money spent, including the disbursement of other assets with a monetary value. The word 'expenditure' will include, *inter alia*, a voluntary payment of money by the taxpayer and the voluntary disbursement of the taxpayer's assets.

Furthermore, the word 'expenditure' will include a *loss* if the word 'loss' can be equated to the word 'expenditure'. However, if the word 'loss' cannot be equated to the word 'expenditure', it is not certain whether it is excluded from section 24C. The fact that section 24C does not include the word 'loss' is an indication that if the word 'loss' cannot be equated with the word 'expenditure', it will, in all likelihood, not be deductible in terms of section 24C.

It was determined that the phrase 'will be incurred', as used in section 24C, implies that the taxpayer will have an unconditional obligation to pay for expenditure in a year of assessment subsequent to the year in which the income in terms of the contract is received or accrues, and this expenditure will be deductible expenditure in terms of sections 24C(1)(a) or (b). Further, this obligation to pay for expenditure must arise from the taxpayer's obligations to perform under the contract.

In chapter 3 the focus will shift to the taxpayer's obligations to perform under the contract and to the related incurral of future expenditure. The contractual terms that may affect the incurral of the future expenditure will also be discussed.

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## **CHAPTER 3: THE INTERPLAY BETWEEN THE TAXPAYER'S OBLIGATIONS TO PERFORM UNDER THE CONTRACT AND THE RELATED INCURRAL OF FUTURE EXPENDITURE**

### **3.1 Introduction**

In chapter 2 it was determined that the phrase 'will be incurred', as used in section 24C, implies that the taxpayer must be able to prove that he will have an unconditional obligation to pay for expenditure in a subsequent year of assessment and that this expenditure will be deductible in terms of sections 24C(1)(a) or (b). It was also determined that there must be a definite connection between the incurral of future expenditure and the taxpayer's obligations to perform under the contract.

Section 24C(2) determines that the Commissioner must be satisfied that the requirements of this section are met before he will permit the allowance to be deducted. It is, therefore, relevant to first consider how the burden of proof will be discharged. The meaning of the words 'contract', 'obligation' and 'performance', as used in section 24C(2), are briefly discussed to establish the connection between the incurral of future expenditure and the taxpayer's obligations to perform under a contract. The remainder of the chapter focuses on how the contractual terms serve as indicators to demonstrate whether there is certainty that the future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract.

### **3.2 The taxpayer's burden of proof**

In the event that the taxpayer and the Commissioner disagree on the deductibility of future expenditure in terms of section 24C, section 102(1)(b) of the Tax Administration Act 28 of 2011 determines that the taxpayer bears the *burden to prove* that an amount is deductible.

The burden of proof refers to the liability that rests on a party to convince the adjudicator of the allegations that he [the party] has made (Schwikkard & Van der Merwe, 2009:599). In terms of section 24C, this implies that, if the taxpayer wants to claim a section 24C allowance, the burden rests on the taxpayer to prove to the Commissioner that the requirements of section 24C are met. If the taxpayer disagrees with the Commissioner's final application of his discretion, the taxpayer has, since 1994, the right to objection and appeal, in terms of section 3(4) of the Act. Chapter 9 of the Tax Administration Act 28 of

2011 regulates the dispute resolution process. Prior to 1994 the taxpayer only had the option to request a review of the assessment issued by the Commissioner (*ITC 1697 63 SATC 146*) (*'ITC 1697'*)<sup>6</sup>.

In civil cases, the burden of proof rests on the appellant to show, *on a balance of probabilities*, that the allegations that he has made do, in fact, exist (Schwikkard & Van der Merwe, 2009:621). The phrase 'on a balance of probabilities', has been defined by Lord Denning in *Miller v Minister of Pensions 2 All ER 372* as follows:

It must carry a reasonable degree of probability, but not so high as is required in a criminal case. If the evidence is such that the tribunal can say: 'We think it more probable than not,' the burden is discharged, but, if the probabilities are equal, it is not. (374)

In *ITC 1601*, a Tax Court case on section 24C, the court held that, when applying section 24C, the burden rests on the taxpayer to prove, on a balance of probabilities, that the section 24C allowance is deductible. It is submitted that the court thereby implied that the taxpayer must prove, on a balance of probabilities, that the various requirements of sections 24C(1) and (2) are met and that the Commissioner should then allow the allowance to be deducted.

The phrase 'on a balance of probabilities' can, however, easily be misinterpreted by a taxpayer. For example, if a taxpayer must prove that the future expenditure will be incurred, he could perhaps argue that, to discharge his burden, he is only required to prove that the *incurral* of future expenditure in terms of a contract is *probable*. He could base his proof, for example, on historical data or by grouping similar contracts together. It is, however, argued that the phrase 'on a balance of probabilities' in this regard does not refer to the provision of evidence that indicates that it is *probable* that the future expenditure will be incurred. Rather, it means that it must be proved that the expenditure will, on a balance of probabilities, definitely be incurred. Contractual terms that a taxpayer can use to prove that the requirements of section 24C are met, are discussed in further detail in 3.4.

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<sup>6</sup> This is important to note, as some of the Tax Court cases on section 24C, which will be discussed in chapter 4, are dated prior to 1994, which implies that the taxpayer could not object and appeal after the Commissioner's final decision.

### 3.3 The meaning of the words ‘contract’, ‘obligation’ and ‘performance’

Section 24C(2) uses the phrase ‘*in the performance of his obligations under such contract*’. The meaning of the phrase must be considered to gain an understanding of its impact on the interpretation of section 24C. Words occurring in this phrase that are of particular importance are: ‘contract’, ‘obligations’ and ‘performance’<sup>7</sup>. Once the meaning of these words has been determined, the interplay between the incurral of the expenditure and the taxpayer’s obligations to perform under the contract can be established (refer to 3.3.3.1).

#### 3.3.1 Contract

A contract is defined as an obligatory agreement that comes into existence if the parties intend to create an obligation, provided that all the requirements for the creation of obligation by agreement are met<sup>8</sup> (Van der Merwe *et al.*, 2007:8).

In the context of section 24C, the form and the nature of the contract in terms of which the income was received, are immaterial (Davis *et al.*, 2013:24C-2). Section 24C is, therefore, not limited to specific types of contracts. It is, however, in terms of section 24C, important that a contract must exist and that the ‘income’ received by or accrued to the taxpayer must originate from *the same contract* that determines the taxpayer’s obligations to perform (refer to chapter 2.3.2).

#### 3.3.2 Obligation

The legal concept ‘obligation’ means a legal tie or bond which binds together legal subjects (persons) (Van der Merwe *et al.*, 2007:2). The content of an obligation consists of

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<sup>7</sup> The terms ‘contract’, ‘obligation’ and ‘performance’ are only briefly discussed as a background for the interpretation of section 24C. It is important to note that the Law of Contract is a separate study field, and these discussions are by no means an in-depth study of the Law of Contract.

<sup>8</sup> The requirements for a valid contract (an obligatory agreement) are, *inter alia*, the contractual capacity of the parties, possibility of performance, legality of the agreement and prescribed formalities (Van der Merwe *et al.*, 2007:8). A discussion of these requirements falls outside the scope of this assignment. For the purpose of this assignment it will be assumed that, when reference is made to a contract or the obligation created by the contract, all the requirements for a valid contract are met.

both a right to performance by the creditor and a duty to render performance by the debtor (Van der Merwe *et al.*, 2007:2).

In the context of section 24C, the taxpayer who wants to claim a section 24C allowance, has received 'income' from the contract and the taxpayer will, therefore, be the party who has an obligation to render a performance. The taxpayer will, accordingly, be the debtor. The person who paid the income to the taxpayer in terms of the contract will be the creditor, as he is the person who has a right to performance<sup>9</sup>.

Section 24C refers, in the plural, to the *obligations* under the contract. The question, therefore, arises: If a contract contains more than one obligation to perform in terms thereof, should each obligation be considered separately when applying section 24C, or should the obligations be considered as an entirety? It is argued that the answer to this question lies in first identifying the actual performances that are required to fulfil the obligations created by the contract. This is discussed further in 3.3.3.

### **3.3.3 Performance**

Kellaway (1995:474-475) describes the word 'perform' as: 'giving effect to the obligation created by the contract, whether affirmative or negative', and 'to fulfil a duty created by the contract'. Kellaway further describes the phrase 'performing the obligations under a contract' as: 'fulfilling the duty created by it, whether to do, or to abstain from doing, a thing'. It is thus clear that it is the taxpayer's *performance* of the obligations under the contract that will fulfil the obligations created by it.

#### **3.3.3.1 The interplay between the taxpayer's obligations to perform under the contract and the related incurral of future expenditure**

It has been established that there must be a definite connection between the incurral of the future expenditure and the contract that determines the taxpayer's obligations to perform. From 3.3.3 is clear that the actual *performance* of the obligations is the action that will determine whether future expenditure will be incurred, and not the obligations itself. It is, accordingly, submitted that, in order to determine whether the future expenditure will be

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<sup>9</sup> In this chapter, and in relation to the obligations that exist in terms of the contract, when reference is made to the *taxpayer*, it can be assumed that he is the *debtor*, as opposed to the other party as the *creditor*.

incurred, it is necessary to identify the performances required to fulfil the obligations created by the contract. Once these performances have been identified, it must be determined whether there is certainty that it will be performed and whether it will lead to the incurral of future expenditure.

To identify these performances, it is necessary to consider the divisibility of the performances required to fulfil the obligations created by the contract.

### **3.3.3.2 Divisibility of performances**

According to De Wet and Van Wyk (1992:145) the divisibility or indivisibility of the *performance* in terms of the contract are of importance. The two considerations that should be taken into account to determine whether a performance is divisible or indivisible are the nature of the performance and the intention of the parties. According to Van der Merwe *et al.* (2007:313), when considering the intention of the parties, the test is to determine whether the parties regard the performance as consisting of separate parts or as a single entity. Van der Merwe *et al.* further state that if a contract contains more than one performance, it gives rise to more than one obligation. Every distinguishable performance in terms of the contract, therefore, creates an obligation (2007:311).

The following example is given by Van der Merwe *et al.* (2007:313) to describe the difference between a divisible and an indivisible performance: Delivery of one horse in terms of a contract is an indivisible performance due to the *nature* of the object. Delivery of a team of two horses can be physically divided in two performances, but if the intention of the parties is that two specific horses must be delivered together to fulfil the obligation, then the performance is indivisible due to the *intention* of the parties.

Further, Van der Merwe *et al.* (2007:314) states that the divisibility of performance does not depend on the divisibility of the counter-performance. In relation to section 24C, this implies that even though a taxpayer might receive only one payment from the creditor in terms of a contract, the taxpayer might be required to render more than one indivisible performance to fulfil more than one obligation created by the contract.

From the aforementioned it is submitted that, in the context of section 24C, if the nature of the performances required to fulfil the obligations under the contract and the intention of

the parties indicate that there are more than one *indivisible performance* in terms of the contract, each indivisible performance should be identified. Once the indivisible performances required to fulfil the obligations under the contract have been identified, it must be determined whether there is certainty that it will be performed and whether it will lead to the incurral of future expenditure.

### **3.3.3.3 Certainty of performance and the related incurral of future expenditure**

In chapter 2 it was shown that 'will be incurred' implies that the taxpayer will, in a subsequent year of assessment, have a definite obligation to pay for expenditure arising from his obligation to perform under the contract. This is opposed to only having a probable or possible obligation to pay for future expenditure. In the OED (2014:definite), the word 'definite' is defined as 'having fixed or exact limits; clearly defined, determinate, fixed, *certain*; exact, precise'. (own emphasis)

From the aforementioned it is submitted that the term 'will be incurred' implies that there must be *certainty* regarding the incurral of future expenditure. The incurral of future expenditure must, therefore, not only be possible or probable. It is further submitted that if the incurral of the future expenditure must be certain, it infers that the *performance* of the obligations that will lead to the incurral of the expenditure must also be certain at the end of the year of assessment in which the taxpayer wishes to apply section 24C.

It is, therefore, necessary to determine which indicators can serve to demonstrate that there is certainty regarding the taxpayer's performance of the obligations under a contract in a subsequent year of assessment. The concept of *certainty* regarding the incurral of future expenditure has also appeared in arguments in Tax Court cases on section 24C, which will be discussed in chapter 4.

## **3.4 Contractual terms and their effect on the certainty that the taxpayer will perform his obligations under the contract and on the certainty of the incurral of the related future expenditure**

Contracting parties express their intention to create specific obligations in their contract through the use of *terms or stipulations* (Van der Merwe *et al.*, 2007:278). According to Van Rensburg, Lotz and Van Rhijn (2010:par 427) the terms in a contract are the

provisions that the contracting parties use to indicate the nature and details of the performances due by the parties. This can include the manner, the time and place of performance. Any other stipulations that the parties may agree upon can also be included as terms in the contract. Examples of common contractual terms given by Van der Merwe *et al.* are: assumption, conditions, time clauses, warranties and exemption clauses (2007:285-297).

Van Huyssteen *et al.* (2010:143) noted that 'In South African Law *conditions* and *warranties* are special contractual terms with particular content and specific consequences' (own emphasis). It is, accordingly, necessary to consider the contractual terms, as they may possibly affect the *certainty* as to whether the taxpayer will perform his obligations under the contract.

In the remainder of the section, three contractual terms, namely, conditions, warranties and time clauses are discussed. The discussion will indicate whether these contractual terms are indicators that serve to demonstrate whether there is certainty that the taxpayer will perform his obligations under a contract and, accordingly, whether future expenditure 'will be incurred'.

### **3.4.1 Conditions**

A condition is a term that qualifies the contractual obligation (Van der Merwe *et al.*, 2007:287). Van der Merwe *et al.* further state that conditions make the operation and consequence of the obligation dependent on an uncertain future event that will either happen or not. *Uncertainty* is, therefore, an indispensable element of a conditional obligation (De Wet & Van Wyk, 1992:149). This implies that the conditions in a contract influence the *certainty* as to whether the obligation will be performed or not. Therefore, the conditions in the contract must be considered when determining whether the *performance* of the obligation in the contract will lead to the incurral of future expenditure. A condition should, however, not be confused with a time clause, which is a term that regulates the performance of the taxpayer with reference to a *certain or uncertain time* in the future (refer to 3.4.3).

## Suspensive and resolutive conditions

Conditions can be classified according to the effect that the fulfilment of the condition has on the obligation, namely, whether it discharges an obligation (resolutive condition) or activates an obligation (suspensive condition) (Van Rensburg *et al.*, 2010:par 436).

A *suspensive condition* is a condition that qualifies the operation of the obligation in that it suspends the obligation until certainty is reached that the condition is fulfilled (Van der Merwe *et al.*, 2007:289). According to Van Huyssteen *et al.* (2010:143), it is generally recognised that an obligation exists, despite the fact that the contract contains a suspensive condition. However, an obligation that is suspended by a condition cannot be enforced until fulfilment of the condition and, therefore, cannot be validly performed (Van der Merwe *et al.*, 2007:293). Accordingly, only once the condition has been fulfilled will there be certainty that the taxpayer will have to perform in order to fulfil the obligation created by the contract and, accordingly, incur the related expenditure.

If there is a *resolutive condition* in the contract, the obligation operates in full and the performance is, therefore, not postponed (Van der Merwe *et al.*, 2007:289). The moment the condition comes in to effect, the obligation to perform is discharged (Kellaway, 1995:475). Thus, when there is a resolutive condition, the continued existence of the obligation is uncertain (Van Huyssteen *et al.*, 2010:143). This implies that, although a taxpayer is already performing in terms of the contract, the taxpayer cannot be sure that he will have to continue to perform in terms of the contract. Accordingly, the uncertain future event might end the taxpayer's obligation to perform under the contract at any time and, therefore, also end the incurral of the related expenditure.

The matter of suspensive and resolutive conditions was addressed in *Nasionale Pers Bpk v KBI*. This case related to the deductibility of the provision for the future payment of bonuses in terms of section 11(a). In this case, it had to be determined whether the expenditure was 'actually incurred', as required by section 11(a) (refer to chapter 2.6.3 for the background of this case). In its argument, *Nasionale Pers Bpk* contested that its obligation to pay bonuses was subject to a resolutive condition, namely, that if the employee was still in the company's employment on 31 October of any given year, the employee would receive a bonus. *Nasionale Pers Bpk*, therefore, contested that an obligation arose to pay bonuses at the end of every month and the obligation *only ceased*

if the employee's services were terminated before 31 October. In reaching his conclusion, Hoexter AR, however, held that on 31 March (the end of the taxpayer's year of assessment) there was an uncertain future event, namely, whether the employee would be in service on 31 October. This event fell outside the company's year of assessment. The question whether *Nasionale Pers Bpk* was *in law obligated* to pay the bonus to an employee could only be answered on 31 October. It was also held that it is unnecessary to make a distinction between a suspensive and resolute condition, as both these conditions refer to an uncertain future event. In this case it was, accordingly, held that the expenditure was only *deemed probable* and there was *no definite or absolute* liability and, therefore, the expenditure was not actually incurred and not deductible in terms of section 11(a).

It is submitted that the same principle laid down in *Nasionale Pers Bpk v KBI* should be applicable when interpreting section 24C. When a contract contains a condition (either suspensive or resolute) which qualifies the obligation to perform, the obligation to perform is conditional and, therefore, only probable and not yet definite or absolute. Further, because the obligation to perform is conditional, the taxpayer cannot be certain whether he will have to perform in terms of the contract. As there is uncertainty regarding future performance, the taxpayer will not be able to demonstrate that future expenditure will be incurred and, therefore, the requirements of section 24C(2) will not be met.

Further, in *Nasionale Pers Bpk v KBI* it was also contested that the expenditure that related to the payment of the bonuses could be distributed amongst the entire population of employees and that the expenditure was an *inevitable commercial reality*. Hoexter AR, however, held that *Nasionale Pers Bpk* could not refer to a *collective obligation* to pay bonuses, as the company had concluded obligations with *each individual employee* and each individual contract was subject to a condition.

It is submitted that this principle is also applicable when interpreting section 24C. As already mentioned in chapter 2.3.2, section 24C(2) requires that the income must be received from *the same* contract that determines the taxpayer's obligation to perform. Section 24C, therefore, also refers to an *individual contract*. Each contract and its related obligations to perform should meet the requirements of section 24C on their own merit. In the event that a taxpayer is involved in several similar contracts containing similar

*conditional obligations*, the contracts cannot be grouped together to determine the probability that the future expenditure will be incurred.

To summarise, in relation to section 24C, conditions in the contract imply that the performance of the obligations under the contract and the related incurral of future expenditure are subject to the occurrence of an *uncertain* future event. Accordingly, the taxpayer will not be able to prove that expenditure will be incurred by him in the performance of his obligations under a contract in the subsequent year of assessment. Conditions in a contract are, therefore, indicators that serve to demonstrate that it is *uncertain* that the future expenditure will be incurred by the taxpayer in the performance of his obligations under a contract.

Following the aforementioned, it is argued that the absence of conditions in a contract can be an indicator that the taxpayer will be able to prove that expenditure will be incurred in the performance of his obligations under a contract in the subsequent year of assessment. This is assuming that there are no other contractual terms that affect the taxpayer's obligation to perform under the contract.

### **3.4.2 Warranties**

Van Rensburg *et al.* (2010:par 447) describe a warranty as 'a contractual undertaking by a debtor that a certain fact relating to his or her performance is or will be as it is stated or promised to be'. Van Rensburg *et al.* further state that, in the case of a warranty, the debtor promises to make good any loss suffered by the creditor due to the fact that the debtor's performance did not realise as warranted. If a debtor cannot perform as promised, he will be held liable for damages for breach of contract (Van der Merwe *et al.*, 2007:296).

In *Schmidt v Dwyer* 1 All SA 6 (C) a warranty was defined as follows:

The general rule is that where a vendor makes a representation or an assertion of a positive and material fact in regard to the quality or quantity of the thing sold, such conduct on his part amounts to a definite promise or warranty, for a breach of which he will be liable. (10)

A taxpayer can, therefore, be liable, in terms of a contract from which he receive income, for damages suffered by a creditor. This implies that a warranty in a contract can, therefore, also lead to the incurral of future expenditure in the performance of the taxpayer's obligations under a contract.

In the context of section 24C, the effect of a warranty in a contract can be explained by the following example: In terms of a sales contract, a taxpayer receives R1 000 from a client and must provide a product to the client. The sales contract also contains a warranty regarding the quality of the product, stating that if the product is defective the client can return the product and the taxpayer will replace it with a new product. Assume that the product has already been delivered during the year of assessment, but the warranty is valid for a period that continues after the end of the year of assessment. The taxpayer will only know whether he is liable for damages when the creditor indicates that the product is defective. Until the latter event, the taxpayer will not know whether he is liable for damages and, accordingly, whether he will have to perform under the warranty in the contract.

The same argument mentioned in 3.4.1 with regards to conditions will, therefore, also apply to warranties. As the taxpayer cannot be *certain* whether he will be liable to compensate the client for damages in terms of the warranty in the contract, he cannot be certain that he will have to incur future expenditure. A warranty in a contract is, therefore, also an indicator that can serve to demonstrate that the incurral of the related expenditure will be *uncertain*, and the taxpayer will, accordingly, not be able to prove that he will incur future expenditure in the performance of his obligations under a contract.

### **3.4.3 Time clauses**

If there is a term in the contract that relates to an event that is certain, but the timing of the event is uncertain, then it is not a condition, but a time clause (De Wet & Van Wyk, 1992:149). Van Huyssteen *et al.* (2010:142) state that, if the parties to a contract contemplate a certain moment or event in the future as a qualification, it is a time clause, as opposed to a condition, even though it is uncertain *when* it will occur.

If a contract contains a time clause it, therefore, regulates the time of the performance and indicates *when* the performance must be rendered. The contract can refer to a specific date on which the performance must be rendered. The contract can also refer to an event

that is *certain* to happen, and when this event occurs, the performance must be rendered in terms of the contract.

Following the aforementioned it is submitted that when parties insert a time clause, their intention is not to make their performance subject to the occurrence of an uncertain future event, but rather that both parties are *certain* and agree that the event will happen. A time clause, therefore, indicates that there is certainty that future expenditure will be incurred in the performance of the taxpayer's obligations under the contract.

#### **3.4.4 Conclusion on contractual terms**

In the context of section 24C, it is important to note that the taxpayer has already received or accrued the income from a contract that obligates him to perform. The client has accordingly already paid or is liable to pay the taxpayer, fully or partially, for the performance that the taxpayer must render to fulfil his obligations under the contract. For the purpose of section 24C, it is important to identify the terms in the contract that indicate whether there is *certainty or uncertainty* regarding the performance of the taxpayer, because this indicates whether there is certainty or uncertainty regarding the incurral of the related future expenditure.

Conditions and warranties in a contract serve as indicators that there is uncertainty regarding the taxpayer's performance of his obligations under a contract and, accordingly, that there is uncertainty regarding the incurral of related future expenditure. A time clause is an indication that there is certainty regarding the taxpayer's performance of his obligations under a contract and, accordingly, that there is certainty regarding the incurral of related future expenditure. It is, therefore, important to distinguish between different contractual terms, as their effect on the certainty regarding the incurral of future expenditure differs.

Kellaway (1995:478) states that, when a court is required to decide whether a term in a contract is a condition or another term that relates to the performance of the contract, the court is entitled to consider the surrounding circumstances and the facts that were available when the contract was made, for example, the customs of trade or the course of the business between the parties. In chapter 4, the available Tax Court cases on

section 24C will be discussed to determine which contractual terms and other circumstances the courts have considered in their interpretation of section 24C.

### 3.5 Conclusion

Chapter 3 showed that to discharge the burden of proof, a taxpayer must prove to the Commissioner, on a *balance of probabilities*, which implies that it is more probable than not, that the various requirements of sections 24C(1) and (2) are met. If the burden is discharged, the Commissioner should allow the section 24C allowance to be deducted.

It was determined that the *performance* that the taxpayer must render to fulfill the obligations created by the contract must lead to the *incurral of the future expenditure*. Each indivisible performance in a contract must be identified and, for each indivisible performance, it must be determined whether the performance will lead to the incurral of expenditure in a subsequent year of assessment. A taxpayer cannot group similar contracts with similar conditional obligations to perform together in order to determine the probability that future expenditure will be incurred in the performance of the taxpayer's obligations under a contract. Each contract should meet the requirements of section 24C on its own merit.

Contractual terms regulate the performance of the parties and can be used as indicators to demonstrate whether there is certainty that future expenditure will be incurred in the performance of the taxpayer's obligations under the contract.

Conditions and warranties are contractual terms that indicate that there is uncertainty regarding the taxpayer's obligations to perform under the contract. These two contractual terms, accordingly, also indicate that there is uncertainty regarding the incurral of related future expenditure. On the other hand, the absence of conditions or warranties, or the inclusion of a time clause in a contract, can indicate that there is certainty regarding the taxpayer's obligations to perform under the contract. The aforementioned is, therefore, an indication that there is certainty regarding the incurral of related future expenditure.

In chapter 4 the indicators, as mentioned, will be tested against available Tax Court cases on section 24C, with specific reference to the concept of 'certainty'.

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## **CHAPTER 4: REPORTED TAX COURT CASES AND BINDING PRIVATE RULINGS RELATING TO THE CERTAINTY OF THE INCURRAL OF FUTURE EXPENDITURE IN TERMS OF SECTION 24C**

### **4.1 Introduction**

In chapter 3 it was determined that certainty must exist that the taxpayer will perform his obligations under the contract and, consequently, that certainty must exist regarding the incurral of related future expenditure. Chapter 4 will discuss available Tax Court cases and binding private rulings ('BPR') where consideration was given to whether expenditure would be incurred by the taxpayer in the performance of his obligations under a contract.

There are currently no court cases decided by a higher court (Provincial Division of the High Court or the Supreme Court of Appeal), that give authority on section 24C. It is, however, meaningful to study available Tax Court cases and BPR, as this provides insight to the Commissioner's interpretation of section 24C and as to whether the Tax Court agreed with the Commissioner's or the taxpayer's interpretation of section 24C.

The judgements and guidance provided by the courts in these cases and by the Commissioner in the BPR will be compared to the findings in chapters 2 and 3. Other findings by the courts that provide guidance on the certainty as to whether 'future expenditure will be incurred' will be identified and critically discussed. Specific emphasis will be placed on the treatment of warranties in contracts and repair and maintenance contracts.

### **4.2 Reported Tax Court cases on section 24C**

#### **4.2.1 ITC 1527 54 SATC 227**

The appellant ('the taxpayer') carried on the business, *inter alia*, of a furniture dealer under the slogan 'your two year guarantee store'. Approximately 80-85% of the taxpayer's sales were effected through installment sale agreements ('the contract'). The contract did not contain any reference to a guarantee. However, a guarantee was provided to the purchaser by means of a separate document.

In terms of the contract, the taxpayer had the obligation to insure the goods purchased by the buyer. The contract authorised the taxpayer to include the premiums payable by him to the insurer in the principal debt of the purchaser and to make monthly premium payments to the insurer.

In submitting his income tax returns, the taxpayer sought to deduct, from his income, allowances in terms of section 24C. The taxpayer argued that his business was conducted on extended terms of credit and that, although the profit on the sale was recognised when the sale was concluded, cost of debt collection was incurred in subsequent periods. The taxpayer also stated that, under the Usury Act 73 of 1968 and in the case of a default in the payment of any installment, there was an administrative burden on the taxpayer to remedy such default. He also stated that if the furniture was defective, he would incur expenditure to collect this defective furniture to have it repaired in terms of the guarantee. It was, however, noted that the suppliers of the furniture were responsible for any repairs to defective furniture and not the taxpayer himself.

The taxpayer, accordingly, argued that he was required to incur staff, communication computer, legal and other administrative costs ('overhead expenditure') in order to effectively manage and service the contracts for up to two years after the sale was concluded. In the light of the aforementioned, the taxpayer argued that he would incur future expenditure in the performance of his obligations under the contracts.

The taxpayer provided the Commissioner with a schedule, indicating that his credit sales amounted to an average of 80% of his total sales. Based on this percentage, the taxpayer used various percentages, most of them lower than 80%, to allocate different overhead expenditure to the credit sales. The taxpayer stated that the expenditure allocated to credit sales represented 'future expenditure' in terms of section 24C. The Commissioner was not satisfied with this schedule and stated that he sought a logical basis for the allocation of the various forms of overhead expenditure to the section 24C allowance. The schedule, together with the standard contract provided by the taxpayer, did not satisfy the Commissioner that the requirements of section 24C had been met and the deduction was, accordingly, disallowed.

Before the court, the taxpayer argued that the Commissioner did not exercise a proper discretion in disallowing the section 24C allowance. He stated that the allowance had been

granted for the previous seven years and that it was obvious that the income from the contracts was utilised to finance future expenditure. He, accordingly, asked for a review of the administrative discretion exercised by the Commissioner<sup>10,11</sup>.

In coming to his conclusion, Melament J, *inter alia*, held that:

- The overhead expenditure in question was not ‘future expenditure’, but *past expenditure*.
- The taxpayer could not provide evidence that the contract imposed any obligation on him in respect of the overhead expenditure in question.
- Any obligation under a guarantee was not an obligation under the contract.
- The only obligation that the taxpayer had under the contract was to include the goods purchased by each buyer under the Group all-risk insurance scheme and to pay the premiums on behalf of those insured. Because the premiums were included in the principal debt, the taxpayer merely acted as a conduit, and had no liability himself under the insurance policy. Melament J held that this obligation in terms of the contract, to administrate the insurance premiums, could entail only a minimal administration cost. The taxpayer did not provide proof as to what this specific administration cost was.
- The obligation that the taxpayer had under the Usury Act was not an obligation under the contract and it was imposed on the taxpayer by virtue of the nature and the manner in which the business was conducted.

Although the court was not required to make a judgement on whether the expenditure would be incurred by the taxpayer in the performance of his obligations under the contract, it is clear from the arguments that Melament J agreed with the Commissioner in

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<sup>10</sup> Prior to 1994, if the taxpayer disagreed with the Commissioner’s final application of his discretion in section 24C, the taxpayer only had the option to request a review of the assessment issued by the Commissioner. Since 1994, the taxpayer has the right to objection and appeal in terms of section 3(4) of the Act (*ITC 1697 63 SATC 146*).

<sup>11</sup> When a special court is required to review the administrative discretion exercised by the Commissioner, the court must decide whether the Commissioner followed the correct procedure in exercising his discretion and whether he applied his mind to the issues and facts before him at the time. The appellant is, therefore, not allowed to bring any new evidence before the special court (*ITC 1601 58 SATC 172*).

disallowing the allowance. Melament J finally concluded that the Commissioner did exercise proper discretion.

#### **4.2.1.1 Definite connection between the incurral of expenditure and the obligation to perform under the contract**

In chapter 2.4.2 it was established that a *definite connection* must exist between the incurral of the future expenditure and the taxpayer's performance of his obligations under a contract. *ITC 1527* confirms this, showing that the contract must stipulate a specific obligation and the performance of this obligation must lead to the incurral of future expenditure. The taxpayer cannot allocate general overhead expenditure to the section 24C allowance unless a definite connection exists. It is, therefore, submitted that, in the absence of this definite connection, there will not be certainty that future expenditure will be incurred by the taxpayer in the performance of his obligations under a contract. *ITC 1527* further shows that, in the absence of a specific obligation to perform under a contract, section 24C cannot be applied.

#### **4.2.1.2 The contract**

In chapter 2.3.2 it was shown that one of the requirements of section 24C is that the income received by or accrued to the taxpayer must be in terms of the *same contract* from which the obligation to perform arises. *ITC 1527* further shows that any obligation that exists outside the contract, even though it might be related to the obligations in the contract, cannot serve as proof that future expenditure will be incurred in the performance of the taxpayer's obligation under a contract.

#### **4.2.2 ITC 1601 58 SATC 172**

The appellant ('the taxpayer') carried on the business of process control engineering. This entailed the sale of computer hardware and measuring instruments. The taxpayer also serviced the hardware, instruments and programs by setting them up to meet the specific requirements of each client. The standard conditions of offer and sale ('the contract') contained a warrant against defective workmanship and materials supplied. It is noted that when the taxpayer supplied manufactured goods, it carried the manufacturer's warranty and the taxpayer was not responsible to replace these goods at his own expense.

Included in the sales price of the goods and service was a profit margin to cover cost likely to be incurred in terms of the warranty in the contract. The taxpayer presented evidence to demonstrate that almost all the contracts required after-sales maintenance, rectification and fine-tuning. This was due to the technical nature of the installations.

The taxpayer deducted an allowance under section 24C in his tax return. He argued that provision was made in the sales price to cover future expenditure that would be incurred in the performance of his obligations under the contract. According to the Commissioner, the taxpayer only had a *contingent liability* and, therefore, the section 24C allowance was not allowed. The taxpayer objected to the assessment and, as in the case of *ITC 1527*, the Tax Court had to review the administrative discretion exercised by the Commissioner.

In delivering his judgement, Van Niekerk J, *inter alia*, held that:

- He agreed that the Commissioner could not be satisfied that expenditure would be incurred if there was only a *contingent liability*.
- ‘Section 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 provision of section 23(e) of the Act.’
- ‘There must be a clear measure of certainty as to whether the expenditure in contention is quantified or quantifiable.’

The aforementioned arguments of Van Niekerk J are discussed further in 4.2.2.1 – 4.2.2.4.

Van Niekerk J specifically stated that the Commissioner invited the taxpayer to provide additional information to satisfy the Commissioner that the section 24C allowance should be allowed, but the taxpayer failed to do so. Although the court was not required to make a judgement on whether the section 24C allowance should be allowed, it is evident from the arguments of Van Niekerk J that he agreed with the Commissioner in disallowing the allowance. Van Niekerk J finally concluded that the Commissioner did exercise proper discretion.

#### **4.2.2.1 The contingent liability**

The deductibility of a *contingent liability* in terms of section 24C came under the radar in *ITC 1601*. As shown in chapter 2.6.1, the words ‘contingent’ and ‘conditional’, as well as

the words 'liability' and 'obligation', can be used as substitutes for each other. Hereafter, where the phrase 'contingent liability' is used by the courts and other literature, it will be assumed that it is similar to a 'conditional obligation', as discussed in chapter 3.4.1.

Clegg and Stretch, however, criticised the judgement in *ITC 1601* (2011:par 11.11.7). Referring to the fact that 'the Commissioner cannot be satisfied that expenditure will be incurred if there is only a *contingent liability*', they said:

If expenditure is not contingent, then there will be no need for the section, as the liability would be absolute and a deduction under section 11(a) could be claimed. The wording requires the Commissioner to be satisfied that expenditure 'will be incurred after the end of such year', making it clear that it is the incurral itself which arises thereafter, and which must, by definition, be uncertain and contingent as at the end of the year in question. 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. (own emphasis)

It is argued that the reason that Clegg and Stretch criticised the judgement in *ITC 1601* is because Van Niekerk J only referred to a *contingent liability* and did not explain the context in which the phrase was used.

As shown in chapter 2.6.4, with reference to case law, when the word 'incurred' is used in section 11(a) it indicates that the taxpayer has, during the year of assessment, incurred an *unconditional obligation to pay for expenditure*. It was also shown in the context of section 11(a), when a taxpayer only has a *contingent liability*, the expenditure will not be deductible under section 11(a). It is on this basis that Clegg and Stretch criticised the judgement in *ITC 1601*, saying that if the liability was not contingent at the end of the year of assessment, the taxpayer could claim a deduction under section 11(a) and then there would be no need for section 24C.

Section 24C, however, refers to the taxpayer's *obligation to perform under a contract* and, as shown in chapter 3.4.1, this obligation can be either conditional or unconditional. If a taxpayer has a conditional obligation to perform under the contract, no certainty will exist that future expenditure will be incurred and the section 24C allowance will not be allowed.

Clegg and Stretch, therefore, rightly say that, for the section 24C allowance to be allowed, ‘there must be in existence an enforceable and uncontingent [unconditional] obligation to perform under a contract, which performance will lead to the incurral of expenditure’.

It is, therefore, clear that, when dealing with section 24C, a distinction must be made between a contingent liability that is not deductible in terms of section 11(a) and a conditional obligation to perform under a contract. It is argued that if Van Niekerk J had rather stated that ‘the Commissioner cannot be satisfied that expenditure will be incurred if there is only a contingent liability [*to perform under the contract*]’, it would have been in agreement with Clegg and Stretch’s and this assignment’s interpretation of section 24C.

#### **4.2.2.2 Interplay between section 24C, section 23(e) and the contingent liability that is not deductible in terms of section 11(a)**

In his judgement, Van Niekerk J referred to the dictum in *Pyott Ltd v Commissioner of Inland Revenue* 13 SATC 121 (*‘Pyott Ltd v CIR’*). In this case, *Pyott Ltd* sold goods in containers and the company was obligated to refund the sales price of the container in the event that it was returned to him. The question was whether the provision made to meet future claims was deductible in terms of section 11(2) of Act 31 of 1941, a section similar to section 11(a) of the Act. The court held that the provision made to meet future claims was a *contingent liability* and consequently disallowed the deduction. It was further held that section 12(e) of the Income Tax Act 31 of 1941, a section similar to section 23(e) of the Act, expressly prohibits the deduction of reserves created for *contingent liabilities*.

Section 23(e) of the Act prohibits a deduction of income carried to any reserve fund or capitalised in any way. Van Niekerk J also held, by referring to *Pyott Ltd v CIR*, that section 24C is an exception to the general rule<sup>12</sup> (the prohibition of the deduction of reserves in terms of section 23(e)). He further held that the courts are entitled to adopt a strict, rather than a liberal view in their application of section 24C to the facts. The courts must, however, still have regard to the specific ambit of section 24C. It is submitted that Van Niekerk J thereby implied that the purpose of section 24C is not to elude section 23(e) nor to open a door for any contingent liability to be deducted under section 24C. Only once

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<sup>12</sup> It is assumed that Van Niekerk J referred to section 23(e) as the *general rule*, because he made this statement immediately after the reference to section 23(e).

the specific requirements of section 24C are met, will an allowance for a reserve be allowed under section 24C.

De Koker and Williams (2011:par 7.10) confirm that a contingent liability is an example of a deduction prohibited by section 23(e). De Koker and Williams (2011: par 7:47) also state that section 24C is an exception to section 23(e), as it permits for the deduction of 'future expenditure' on contracts. The aforementioned statements by De Koker and Williams and Van Niekerk J, namely that section 24C is an exception to section 23(e), should be carefully interpreted, especially with reference to the *contingent liability*.

If the taxpayer has created a reserve for a contingent liability, incurred in the pursuance of the performance of his obligation under the contract, the question arises: Is the amount of the reserve created for the contingent liability then deductible under section 24C? It submitted that the answer is 'no', because the section 24C allowance is based on the taxpayer's obligation to perform under the contract and not on the contingent liabilities existing at the end of the year of assessment.

To explain the argument, the following example is provided:

In year 1 taxpayer A receives R1 000 from client B in terms of a contract. Taxpayer A has an unconditional obligation under the contract to build a structure for client B in year 2. The contract price consists of R400 for bricks, R400 for labour and R200 profit for taxpayer A. Taxpayer A will buy half of the bricks at the end of year 1 and the other half in year 2. At the end of year 1, taxpayer A bought bricks from supplier X for R200, but in terms of the supplier's contract, taxpayer A will only be liable to pay supplier X if he is satisfied with the quality of the bricks. Taxpayer A only inspects the bricks in year 2. At the end of year 1 taxpayer A, therefore, only has a contingent liability to pay supplier X and the R200 is not deductible in terms of section 11(a).

When calculating taxpayer A's section 24C allowance, the allowance is so much of the income that will be utilised in whole, or in part, to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under the contract. In terms of the contract, taxpayer A will incur future expenditure to the value of R800 (R400 for bricks and R400 for labour) in the performance of his obligation under the contract. The section 24C allowance will, therefore, be R800. It is thus clear that the section 24C

allowance is based on the unconditional obligation to perform under the contract, and not on the existing conditional liability to pay supplier X. The starting point for calculating the section 24C allowance is, therefore, the contract which is independent of the taxpayer's existing contingent liabilities at the end of the year of assessment.

It is, therefore, argued that although the section 24C allowance can be equal to or similar to a contingent liability incurred by the taxpayer in the pursuance of the performance of his obligation under the contract, it is not the *contingent liability* that is deductible under section 24C. The amount deductible under section 24C is an amount that represents all the future expenditure that will be incurred by the taxpayer in the performance of his obligation under the contract.

#### **4.2.2.3 The warranty**

In *ITC 1601* it was not specifically stated what the Commissioner classified as a contingent liability. It is, however, assumed that he referred to the warranty for defective workmanship, consisting of after-sales maintenance, rectification and fine-tuning, as required by the clients. As discussed in chapter 3.4.2, when a taxpayer is obligated to perform in terms of a warranty in a contract, he cannot be *certain* whether he will have to perform and incur future expenditure until the client informs him that his workmanship is defective. His obligation to perform in terms of the contract is, therefore, conditional and dependent on the occurrence of an uncertain future event. Thus, even though the Commissioner in *ITC 1601* only referred to a *contingent liability* that was not deductible under section 24C, the taxpayer's performance under the warranty in the contract was only *conditional* and the section 24C allowance was, therefore, correctly not allowed.

#### **4.2.2.4 Clear measure of certainty that the expenditure is quantified or quantifiable**

Section 24C provides for a deduction of an *allowance* for future expenditure as opposed to a deduction for expenditure actually incurred. Due to the nature of the section 24C allowance, unless the contract quantifies the exact amount of future expenditure to be incurred by the taxpayer, the taxpayer will not know what the exact amount of future expenditure will be until he actually incurs it. Van Niekerk J in *ITC 1601* accordingly mentioned that the future expenditure must be *quantified or quantifiable*. He did not

explain this argument, and only added, as if to emphasise his argument, that 'since a deduction is sought, this must arise from an obligation and must be quantifiable'.

*CIR v Edgars Stores Ltd* was a case dealing with the deductibility of expenditure in terms of section 11(a). It was held that if an unconditional liability was incurred, but it cannot be quantified, then the amount must be estimated based on available information and claimed in that tax year. The deduction in terms of section 11(a), therefore, does not depend on whether the amount is already quantified. If a reliable estimate of the expenditure can be made then the deduction should be allowed.

It is argued that the same principle laid down in *CIR v Edgars Stores Ltd* should apply in section 24C. When an enforceable and unconditional obligation under a contract exists and there is certainty that the performance of this obligation will lead to the incurral of expenditure, the amount must be estimated if it is not already quantified in the contract. From *ITC 1527* (refer to 4.2.1) it is, however, clear that the Commissioner must be satisfied that this amount is not only based on vague allocations of expenditure. The Commissioner will expect a detailed schedule illustrating that there is a definite connection between the estimate of future expenditure that will be incurred and the obligation to perform under the contract.

It is, accordingly, submitted that the 'clear measure of certainty as to whether the expenditure in contention is quantified or quantifiable' referred to by Van Niekerk J will be obtained when the taxpayer has:

- an unconditional obligation to perform under a contract that will lead to the incurral of future expenditure, and
- the estimate of the amount of future expenditure is based on fair and reasonable grounds.

Lastly, it is submitted that if the contract does not quantify the future expenditure to be incurred in terms of the contract it will not, in itself, be an indication that the incurral of the future expenditure is uncertain.

### 4.2.3 ITC 1667 61 SATC 439

This case was introduced in chapter 2.3.2, where it was shown that one of the requirements of section 24C is that the income must be received by or accrued to the taxpayer in terms of the *same contract* from which the obligation to perform arises. In this case, reference is, however, also made to the incurral of *future maintenance costs*.

The appellant's ('the taxpayer') business was the selling, letting and repairing of office equipment. The taxpayer usually concluded two contracts with each client. The first contract was a 60-month rental contract, in terms of which the taxpayer received monthly rental income. The second contract was a maintenance contract that provided for the maintenance of the equipment during the duration of the rental agreement. The taxpayer did not receive any additional income in terms of the maintenance agreement, as the remuneration was provided for under the rental agreement. After the contracts were concluded, the taxpayer discounted the future payments and ceded his rights to future rental income to B (a third party) in return for payment from B. In doing so, the taxpayer received a lump sum shortly after the rental agreement was concluded. The taxpayer, however, remained liable for the maintenance of the equipment over the 60-month period in terms of the maintenance contract.

The taxpayer deducted a section 24C allowance in the calculation of his taxable income, arguing that he did receive income in terms of a contract and that he would incur future expenditure to perform his maintenance obligations under the contract.

The Commissioner disallowed the deduction, and provided the following reasons:

- The incurral of the maintenance expenditure is *conditional* upon the client using the equipment. The rental and the maintenance agreement can be cancelled by the client and the future maintenance expenditure is thus uncertain or of a contingent nature. The Commissioner referred to *ITC 1601* to support this contention.
- The rental contract and the maintenance contracts were two separate contracts.
- The taxpayer derived his income from the discounting transaction, which was separate to the contract that obligated him to maintain the equipment.

The taxpayer objected to each of the Commissioner's reasons:

- The taxpayer referred to the criticism given by Clegg and Stretch on the judgement in *ITC 1601* and further argued that it could not have been the Legislator's intention to disallow expenditure under section 24C that was contingent upon an actual malfunction occurring.
- The rental agreement was the cause for the maintenance contract and the maintenance contract was intrinsic to the rental agreement.
- The discounting transaction was directly linked to the rental agreement and, therefore, formed an integral part of the scheme.

Blignaut J agreed with Commissioner that the section 24C allowance should not be allowed because the income was not received from the *same contract* that obligated the taxpayer to perform.

It should be noted that Blignaut J chose only to conclude on the Commissioner's third reason for not allowing the allowance. He did not indicate whether he agreed with the Commissioner that the future maintenance expenditure was uncertain and contingent in nature. This is unfortunate, as it could have provided some further insight into the determination of whether the incurral of future maintenance costs under a contract is certain or uncertain and, therefore, deductible in terms of section 24C, or not. Future maintenance cost is discussed further in 4.4.

#### **4.2.4 ITC 1697 63 SATC 146**

This case is the only Tax Case on section 24C in which the taxpayer succeeded in convincing the court that the Commissioner's decision to disallow the section 24C allowance was incorrect.

The appellant ('the taxpayer') was a shareblock company, operating a time share consisting of flats. A Use Agreement existed between the taxpayer, on the one hand, and each member that acquired a shareblock, on the other hand. Each member was bound in terms of their individual Agreement of Sale to this one Use Agreement ('the contract'). The contract determined that the members were required to pay levies to the taxpayer and the taxpayer had certain obligations that he had to fulfil.

The taxpayer's obligations in terms of the contract were clearly defined and included, *inter alia*, the repair, upkeep, renovation, control, management and administration of the company, the property and the immovable property, including all the flats, and the payment of any obligations of the company in connection with the aforementioned. The directors had to estimate, annually, the amount which was required to meet the aforementioned obligations and, accordingly, determine the levy amount that each member had to pay. The contract also determined that the levy could include an amount to be held at reserve to meet any anticipated future expenditure that was not of an annual nature, such as expenditure to be incurred for the redecoration or renovation of the company's property and the replacement of movable property. At the annual general meeting, the financial director of the company had to provide a detailed budget for the following three years, listing all the items, for annual and non-annual expenditure, relating to the administration of the scheme and for the maintenance of the fixed and movable property.

The budget included a list that carefully predicted *when and in which year* the non-annual expenditure would become payable. This was important, because the members did not have the right to furnish and maintain the units themselves. The taxpayer, therefore, estimated when certain items in the units would reach the end of their life, and then budgeted to replace all similar items in all the units at the same time. Thus, the taxpayer fulfilled his obligations in terms of the contract uniformly and not randomly.

According to the taxpayer, these aforementioned obligations, for both annual and non-annual expenditure, led to the incurral of future expenditure and he, therefore, claimed the section 24C allowance against the levy income received in terms of the contract.

The Commissioner disallowed the allowance based on two reasons:

- The incurral of the future expenditure is left to the discretion of the directors and, therefore, the obligation to incur future expenditure does not arise from the contract.
- The contract does not make it possible for the Commissioner to make a reasonable estimate of the *quantum* of the future expenditure.

Galgut J addressed the Commissioner's contentions as follows:

- 'The contract is an ongoing agreement, which creates a set of rights and obligations which will arise in each and every year'. He stated that the fact that the directors have discretion to provide for whatever becomes necessary to maintain or replace fixed or immovable property, does not change the fact that it is the contract that determines the taxpayer's obligation to perform.
- Although the contract does not specify the quantum of the future expenditure, the directors have the discretion to decide *when and how* the obligations will be fulfilled. Each year's budget accordingly carefully estimates the amount of expenditure that will be incurred to fulfil the obligation under the contract. Galgut J referred to *ITC 1601* where it was stated that 'there must be a clear measure of certainty as to whether the expenditure in contention is quantified or quantifiable'. Galgut J compared the current case with *ITC 1601*, saying that in *ITC 1601* the future expenditure was contingent, because it might never arise. In this case, however, the taxpayer's liability for the future expenditure was far from contingent, it was *unconditional* and the amount was *certain*.

He further referred to *CIR v Edgars Stores* where it was held that in situations where the *quantum* of the amount is not specified in the contract, it should be estimated based on what is fair and reasonable.

Galgut J also stated that, when referring to a 'contract' in section 24C and when it is said that the liability must be unconditional in terms of the contract, it does not refer to a contract which the taxpayer might conclude with a supplier in the pursuance of the performance of his obligation under the contract. The contract refers to the contract in terms of which the taxpayer received income and under which he has an obligation to perform and this obligation to perform must, accordingly, be unconditional. This is in agreement with what Clegg and Stretch observed when commenting on *ITC 1601* (refer to 4.2.2.1).

The appeal succeeded and the deduction in terms of section 24C was allowed. Three matters came to the foreground that require further discussion.

#### **4.2.4.1 The discretion of the directors to affect performance under the contract**

According to Galgut J's argument in *ITC 1697*, when the directors of a company have the discretion to decide when and how the taxpayer's obligation under the contract should be performed, the obligation to perform is still in terms of the contract and not in terms of the directors' decisions.

It is argued that if the directors have the discretion to decide *when and how* the taxpayer's obligation under the contract should be performed, it indicates that there is no uncertainty regarding whether the obligation *must* be performed. There is certainty regarding the taxpayer's obligation to perform under the contract and the directors' discretion merely give effect to the performance of the obligation. This is similar to a time clause, as discussed in chapter 3.4.3. If parties insert a time clause in a contract, their intention is not to make the performance subject to the occurrence of an uncertain future event. They are certain that the performance must be rendered, although the timing of the performance is not certain. In this case, the taxpayer's obligation to perform was certain, but the timing and manner of the performance was left to the discretion of the directors.

#### **4.2.4.2 Quantifiable expenditure**

From *ITC 1697* it is clear that if a contract does not specify the *quantum* of the expenditure that the taxpayer must incur in order to fulfil his obligation under the contract, the amount of the allowance can still be quantified based on a fair and reasonable estimate. *ITC 1697*, however, clearly shows that these estimates should be detailed and they should correlate with the specific obligation that the taxpayer has under the contract. This is in agreement with the conclusion in *ITC 1527* (refer to 4.2.1.1), where the taxpayer attempted to allocate general overhead expenditure to the section 24C allowance, but failed to do so, because such allocation of the expenditure did not correlate with the obligations under the contract.

#### **4.2.4.3 Future maintenance costs**

An interesting element of the judgement in *ITC 1697* is that it allowed a deduction for future maintenance costs. Galgut J, however, specifically stated that, in this case, the obligation to perform was unconditional. The following questions can, however, be posed regarding the maintenance cost: What determines whether maintenance, renovation or the replacement of movable property will be required? Could there be uncertainty as to

whether the aforementioned maintenance will be required? For example, the extent of maintenance might be considerably greater if a storm damages the building, than if there is no severe damage due to unforeseen circumstances. This triggers the question of whether maintenance, renovation or the replacement of movable property is, in fact, subject to damage being suffered, or to the fact that something must break, and therefore conditional? As seen from *ITC 1667* in 4.2.3, the Commissioner contended that the incurral of the maintenance expenditure under the maintenance contract was conditional upon the client using the equipment. The taxpayer's obligation to performance under the contact was, therefore, uncertain or of a contingent nature. In *ITC 1667* the judge did, however, not comment on this and it was, therefore, uncertain whether he agreed or disagreed that the taxpayer's performance under the maintenance contract was contingent in nature and that the taxpayer only had a conditional obligation to perform under the maintenance contract.

In *ITC 1697* the contract was, however, described as an *ongoing agreement*. Every year the directors determined what the necessary maintenance, renovations or the replacement of movable property was and, accordingly, how much the related expenditure would be and what the levy amount payable by the shareholders should be. Therefore, when the levies were received, there was certainty about the expenditure to be incurred in a subsequent year of assessment. This *ongoing agreement* could have been the taxpayer's saving grace in *ITC 1697*. Maintenance contracts are discussed further in 4.4.

#### **4.2.5 ITC 1739 65 SATC 43**

This tax case and the criticism on this judgement have already been discussed in chapter 2.5 with specific reference to the meaning of the word 'expenditure'. In *ITC 1739* reference is, however, also made to a 'warranty' in the contract and the facts are, therefore, presented here again:

The taxpayer was a manufacturer of certain products (held as trading stock) which were sold with a manufacturer's warranty to various motor assembly plants. The motor assembly plants are referred to as original equipment manufacturers ('OEM'). The OEM, in turn, supplied completed vehicles to dealers and distributors. In the event of a warranty claim, the OEM would claim the parts necessary for the repair of the vehicle from the taxpayer. The taxpayer wished to utilise the section 24C allowance, but the Commissioner

disallowed the taxpayer's claim on the basis that it was a warranty claim and, therefore, a *contingent liability*.

The taxpayer appealed to the Tax Court, arguing that when determining the price for his products he, *inter alia*, considered the terms of the manufacturer's warranty since he, in the event of a claim, would incur a cost to honour his obligation under the warranty in the contract.

In his judgement, Joffe J did not indicate whether the future expenditure to be incurred in terms of the warranty in the contract was indeed only *contingent in nature*, but he disallowed the deduction, based on the fact that the cost to honour the obligation under the warranty in the contract represented a *loss* and not 'expenditure'<sup>13</sup>.

#### **4.2.5.1 The warranty**

Based on chapter 3.4.2, it is suggested that the Commissioner was, indeed, correct in arguing that the warranty only led to a contingent liability. He, however, only made reference to a *contingent liability*. This should have been rephrased as the contingent liability was specifically *in terms of the contract* or, stated otherwise, *the obligation to perform under the contract was conditional*. If a contract contains a warranty, the taxpayer cannot be *certain* that he will be liable to compensate the client for damages until the client indicates that the item is, indeed, defective.

#### **4.2.6 Special Board Decision No. 129<sup>14</sup>**

The appellant ('the taxpayer') sold policies and earned commission on all his sales. The taxpayer had an obligation to refund the commission if the policies were cancelled within two years. The taxpayer estimated, based on the cancellation history, his expected obligation to refund the commission, and deducted a section 24C allowance for this future expenditure from the commission income received.

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<sup>13</sup> Whether closing stock on hand can be included as 'future expenditure' in terms of section 24C will be discussed in further detail in chapter 5.4.

<sup>14</sup> Tax appeals, in the first instance, are heard either by the Tax Board or the Tax Court (SARS:2014). Tax Board Decisions, previously known as Special Board Decisions, are issued by the Tax Board and are binding on the parties, but do not create a precedent.

The Commissioner disallowed the deduction, stating that he was not satisfied that the amount would necessarily be incurred by the taxpayer in the performance of his obligations under the contract.

Rosenberg, the Chairman of the Board, held that the expected obligation was only a contingent liability and that the obligation to refund the commission had not yet vested. It was also held that the fact that reliable data was available to enable a reasonably accurate projection of cancellation figures did not change the character of the obligation. The obligation of the taxpayer remained *contingent* in relation to each individual policy. The section 24C allowance was, accordingly, not allowed.

#### **4.2.6.1 Collective obligations**

In chapter 3.4.1 it was shown from *Nasionale Pers Bpk v KBI* that a taxpayer cannot group similar contracts with similar conditional obligations together to determine the probability that future expenditure will be incurred in the performance of the taxpayer's obligations under the contracts. Further, in chapter 3.1, it was also shown that a taxpayer cannot argue that, to discharge his burden of proof, he must only prove that the incurral of future expenditure in terms of a contract is *probable*.

Rosenberg, therefore, also correctly held that each individual obligation should be considered to determine whether the section 24C requirements are met. As long as the obligation to perform under the individual contract is conditional, the requirements of section 24C remain unmet.

### **4.3 Binding Private Rulings ('BPR')**

A BPR is issued by the Commissioner in response to a specific proposed transaction and states how the Commissioner would interpret and apply the provisions of the tax laws in relation to the transaction (SARS:2014(1)). It is only binding on that particular transaction and usually only valid for a specified period. A published BPR provides only limited information regarding the proposed transactions, but it nevertheless provides insight into the Commissioner's interpretation of certain provisions.

#### **4.3.1 BPR 6: The application of section 24C in the context of a repair and maintenance contract**

The proposed transaction was as follows: The taxpayer manufactured and sold assets that required repairs and maintenance. He would enter into a separate repair and maintenance contract ('the contract') with each client. The contract was specifically not a warranty, but covered the known and anticipated repair and maintenance costs of the asset, for an agreed fee that was payable on a monthly basis by the client. The monthly fee was calculated based on the anticipated costs of repairs and maintenance, which the taxpayer was obliged to perform in relation to such asset in terms of the contract.

According to BPR 6, the taxpayer was entitled to a section 24C allowance in respect of the fees accruing under the contract. It is interesting to note that no distinction was made by the Commissioner between contingent maintenance costs and unconditional maintenance costs. Also refer to 4.4 for further discussion on future maintenance costs.

#### **4.3.2 BPR 106: Application of section 24C to a maintenance trust**

The proposed transaction was as follows: The taxpayer was a trust that would be responsible for the maintenance of the burial grounds at a private cemetery. Clients who wanted to be buried at the cemetery would pay a fee to Company A in terms of a burial agreement for a final resting right at the cemetery. At the same time, they would pay a fee, in terms of the burial agreement, to the trust for the maintenance of the burial grounds. The trust had to, in terms of the burial agreement, maintain the grounds in perpetuity and would incur the maintenance costs as, and when, required.

According to BPR 106, the taxpayer was entitled to a section 24C allowance in respect of his obligation under the burial agreement. The future maintenance expenditure was, therefore, deductible. This ruling, however, specifically stated that it was not applicable in relation to expenses of a contingent nature. No indication was given as to which expenses in the proposed transaction would be classified as *contingent in nature*. Refer to 4.4 for further discussion on future maintenance costs.

#### 4.4 Repair and maintenance contracts – contingent or unconditional?

In the light of BPR 6, BPR 106 and the judgements in *ITC 1601*, *ITC 1697* and *ITC 1739*, it seems that future maintenance costs can be categorised into three groups:

- Under a maintenance and repair contract, the taxpayer can have an unconditional obligation to maintain and repair specified assets, in which event his obligation is certain, even though the timing of the performance is uncertain or subject to the discretion of the directors. If the contract does not specify the quantum of the future maintenance and repair cost, it should be estimated based on fair and reasonable grounds. The future maintenance costs are known or can be anticipated, as shown in *ITC 1697* and BPR 6. A section 24C allowance will, therefore, be allowed for future maintenance costs to be incurred in the aforementioned circumstances.
- The terms of the maintenance and repair contracts can determine that the taxpayer is only required to repair or maintain the assets in the event of malfunction, damage or breakage. This is similar to a warranty in a contract that can obligate a taxpayer to perform specified maintenance and repairs on an asset in the event that the asset or services rendered are defective (*ITC 1601* and *ITC 1739*). As shown in 3.4.1 and 3.4.2, the taxpayer's obligation will be conditional upon the occurrence of an uncertain future event and, therefore, a section 24C allowance will not be allowed for estimated future repair and maintenance costs.
- The terms of the maintenance and repair contracts can also indicate that the taxpayer has both conditional and unconditional obligations to perform under the same contract (BPR 106). As shown in 3.3.3.2 if the nature of the performances required to fulfil the obligations under the contract and the intention of the parties indicate that there are more than one *indivisible performance* in terms of the contract, each indivisible performance should be identified. Thus, if some of the performances required to fulfil the taxpayer's obligation under the contract are conditional upon the happening of an uncertain future event, the section 24C allowance will not be allowed for the related future expenditure.

The terms of maintenance and repair contracts should be carefully read to determine the nature of the performances required to fulfill the obligations under the contract and

whether these performances are conditional or unconditional, as this will influence the deductibility of the future expenditure under section 24C.

#### 4.5 Conclusion

Chapter 4 showed that certain circumstances will indicate whether there is certainty that future expenditure will be incurred by the taxpayer in the performance of his obligations under a contract.

The courts have confirmed that there must be a definite connection between the taxpayer's performance of his obligation under the contract and the incurral of future expenditure. General overhead expenditure cannot be allocated as part of the section 24C allowance, unless it can be shown that it directly relates to the obligation under the contract.

The performance of the obligation that will lead to the incurral of future expenditure must be in terms of the *same contract* from which income was received by, or accrued to, the taxpayer. The obligation under the contract does not include obligations that exist outside the contract, even though they might be related to the obligations in the contract.

A distinction must be made between a contingent liability that is not deductible in terms of section 11(a) and a conditional obligation to perform under a contract. The section 24C requirements will not be met if the taxpayer only has a conditional obligation to perform under a contract. Whether the section 24C requirements are met should, therefore, not be tested against the existence of a contingent liability that is not deductible under section 11(a), but against the obligation to perform under the contract, which must be unconditional and which must lead to the incurral of future expenditure.

Section 24C is an exception to section 23(e), provided that any reserve for 'future expenditure' meets all the requirements in terms of section 24C and the amount of the reserve is calculated in terms of section 24C.

A warranty in a contract indicates that a taxpayer only has a conditional obligation to perform under a contract, and the section 24C allowance will, therefore, not be allowed for future expenditure relating to the warranty.

Unquantified future expenditure to be incurred in terms of a contract, will not indicate that the incurral of the future expenditure is uncertain. If the taxpayer has an unconditional obligation to perform under a contract and the amount is quantifiable, provided all other requirements of section 24C are met, the section 24C allowance will be allowed. If the amount is not already quantified in the contract, the estimate of the amount of future expenditure must be based on fair and reasonable grounds.

When the directors of a company have the discretion to decide when and how the taxpayer's unconditional obligation under the contract should be performed, the *obligation* to perform remains in terms of the contract and it is only the actual performance of the obligation that is subject to the directors' discretion. Therefore, the taxpayer's obligation to perform is certain and it is only the manner and timing of the performance that are uncertain, because they are dependent on the directors' discretion.

Similar contracts with conditional obligations to perform cannot be grouped together to determine the probability that future expenditure will be incurred. Historical data, indicating the probability that future expenditure will be incurred under a contract, does not change a conditional obligation to perform under the contract to an unconditional obligation to perform under the contract.

The terms of maintenance and repair contracts should be carefully read to determine whether they represent a conditional obligation to only repair or maintain an asset in specified circumstances, whether the taxpayer is unconditionally obligated to maintain and repair certain assets, or whether the contract contains both conditional and unconditional obligations to maintain and repair assets. Only when the taxpayer's performance of his obligations are unconditional will there be certainty regarding the incurral or the related future expenditure, and provided that all other requirements of section 24C are met, will a section 24C allowance be allowed.

SARS recently issued a *IN 78* to explain their interpretation of section 24C. In chapter 5, any new guidelines introduced by *IN 78*, relating to this assignment's established interpretation of section 24C, will be discussed.

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## **CHAPTER 5: NEW GUIDELINES PROVIDED FOR BY *IN 78* RELATING TO THIS ASSIGNMENT'S ESTABLISHED INTERPRETATION OF SECTION 24C**

### **5.1 Introduction**

Chapters 2, 3 and 4 established, with reference to this assignment's first two research questions, and based on court cases, academic writing and other material:

- The meaning of the word 'expenditure', as used in section 24C.
- Indicators that will serve to demonstrate whether future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract.

In July 2014 SARS issued *Interpretation Note: No. 78, Allowance for future expenditure on contracts ('IN 78')* (SARS, 2014(3)) providing guidelines on the interpretation of section 24C. An Interpretation Note is SARS's interpretation of a provision in the Act and it does not have the force of law (Stiglingh *et al.*, 2014:13). A taxpayer may, therefore, challenge the practice of SARS, as set out in an Interpretation Note, if he disagrees with the interpretation.

In this chapter, any guidelines, provided for by *IN 78*, but which were not already discussed in chapter 2, 3 or 4, are discussed with specific reference to:

- The meaning of the word 'expenditure', as used in section 24C; and
- Indicators that will serve to demonstrate whether future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract.

Shortcomings to these guidelines are emphasised and, if necessary, suggestions regarding these guidelines are provided.

In addition, in chapter 2.5 it was shown, with reference to the evaluating commentary by JutaLaw on *ITC 1739*, that some uncertainty exists as to whether trading stock held by the taxpayer at the end of the year of assessment, that will be utilised by the taxpayer in the performance of his obligation under a contract, will qualify as 'future expenditure' in terms of section 24C(1). *IN 78*, however, states that the aforementioned does not represent

'future expenditure' and this chapter, therefore, ends with a discussion of the interplay between section 24C and trading stock.

## 5.2 Expenditure

Paragraph 4.2.1(a) of *IN 78* states that it is important to distinguish between expenditure and losses, because the two are different and section 24C only applies to 'future expenditure'. *IN 78* discusses the meaning of the word 'expenditure' with reference to authoritative court cases and no new guidance on the meaning of the word 'expenditure' is provided for by *IN 78*.

*IN 78* also refers to court cases where a distinction was made between 'expenditure' and 'losses'. It refers to *Joffe & Co (Pty) Ltd v CIR* where Watermeyer CJ explained the difference between 'losses' and 'expenditure'. Watermeyer CJ held that, in relation to trading operations, expenditure usually means the *voluntary payment of money*, whereas *losses* is sometimes used to signify a deprivation suffered by the loser, usually an *involuntary deprivation*. *IN 78*, however, does not refer to Watermeyer CJ's next argument, as discussed in chapter 2.5.1, where it was shown that in certain circumstances a *loss* can be equated with the meaning of the word 'expenditure'.

*IN 78* further refers to *COT v Rendle* 26 SATC 326. In this case, a distinction was made between *designed expenditure*, representing money voluntarily spent and *fortuitous expenditure*, representing 'money involuntarily spent because of some mischance or misfortune which has overtaken the taxpayer'. *IN 78*, however, does not indicate how this case should be interpreted in the light of section 24C. It is thus not certain whether *IN 78* argues that:

- Fortuitous expenditure should be equated to 'losses' and is, therefore, not deductible under section 24C, or
- Fortuitous expenditure is still money spent and is, therefore, deductible under section 24C.

Thus, although *IN 78* clearly states that section 24C is only applicable to future expenditure, and it provides guidelines to the meaning of the word 'expenditure', the following shortcomings are identified:

- It is not clear whether SARS is of the opinion that fortuitous expenditure or money involuntarily spent is a *loss* and, therefore, not deductible under section 24C; and
- *IN 78* does not specify whether a *loss* which can, in certain circumstances, be equated to the word 'expenditure', as was shown by Watermeyer CJ, is deductible under section 24C.

It is suggested that *IN 78* needs to be amended to provide clarity in this regard.

### **5.3 Indicators that will serve to demonstrate that future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract.**

Paragraph 4.2.1(b) of *IN 78* discusses, under the heading 'will be incurred in a subsequent year of assessment' the phrase 'will be incurred' and the fact that the incurrence must flow from the taxpayer's obligation to perform under the contract.

According to paragraph 4.2.1(b) of *IN 78*, the phrase *will be incurred in a subsequent year of assessment* indicates that:

[T]he 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 (SARS, 2014(3):9). (own emphasis)

From the aforementioned, it seems that a taxpayer will obtain a high degree of certainty that the expenditure will be incurred in a subsequent year of assessment if he can prove that there is a *high degree of probability and inevitability* that the expenditure will be so incurred.

*IN 78* also states that:

[It is] not possible to specify the industries or particular circumstances in which the taxpayer will always be able to demonstrate and prove the required level of certainty.

[T]he *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 (SARS, 2014(3):10). (own emphasis)

From paragraph 4.2.1(b) of *IN 78* it seems that *IN 78* provides the following *new indicators* that will serve to demonstrate that future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract:

- A *high degree of probability and inevitability* must exist that the expenditure will be incurred by the taxpayer, which will indicate that there is a *high degree of certainty* that the expenditure will in fact be incurred in a subsequent year of assessment.
- The taxpayer's performance cannot only be *potentially* contractually obligatory, because of an act or event other than just the taxpayer's client or customer taking action.

*IN 78* gives the following example that provides insight into the meaning of the phrases a *high degree of probability, inevitability* and *certainty* that expenditure will be incurred and a *potential contractual obligation* to perform under a contract.

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 to satisfy the Commissioner that the expenditure will be incurred exists in such a situation. The fact that the customer 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 customer taking action (for example, the customer choosing the colour of the tiles), but not when performance is dependent on further events which *may or may not occur*.

At 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 under the contract*, which gave rise to the advance income and that the Commissioner is satisfied that the expenditure will be incurred in a subsequent year of assessment. (SARS, 2014(3):10). (own emphasis)

Although *IN 78* provides the aforementioned example, it does not define the words ‘inevitability’ and ‘probability’ or the phrases ‘a high degree’ and ‘potentially contractually obligatory’. These words has also not been previously introduced in court cases on section 24C, the *Explanatory Memorandum* or in section 24C itself. The question therefore arises whether these words and phrases, if they are not defined in *IN 78*, might cause confusion when interpreting section 24C?

The meaning of words and phrases ‘inevitability’, ‘probability’, ‘certainty’ and ‘a high degree’ will be discussed in 5.3.1 and the meaning of the phrase ‘potentially contractually obligatory’ will be discussed in 5.3.2. It will be determined whether these words and phrases are in actual fact new indicators as to whether there is certainty that expenditure will be incurred by the taxpayer in the performance of his obligations under the contract.

### **5.3.1 ‘Inevitability’, ‘probability’, ‘certainty’ and ‘a high degree’**

#### **5.3.1.1 Inevitability**

The word ‘inevitable’ is described as:

That cannot be avoided; not admitting of escape or evasion; unavoidable. In extended use: that cannot fail or is bound to occur, appear, be used, etc.; that is inherent (in) or naturally belongs to (OED, 2014:inevitable).

In the context of section 24C, the word *inevitable* indicates that the incurral of the expenditure in a subsequent year of assessment cannot be avoided. It is submitted that when a taxpayer has an unconditional obligation to perform under a contract, which will lead to the incurral of expenditure (as discussed in chapter 3.4.1), the expenditure will be *inevitable*. Thus, although the word *inevitable* is used for the first time in the context of section 24C, it does not introduce a new indicator as to whether there is certainty that the future expenditure will be incurred. It confirms the established interpretation regarding unconditionality in chapter 3.4.1.

### **5.3.1.2 Probability**

The word 'probable' is described as:

Having an appearance of truth; that may in view of present evidence be reasonably expected to happen or be the case; likely (OED, 2014:probable).

In the context of section 24C, the word *probable*, therefore, indicates that it is likely or reasonably expected that the expenditure will be incurred in a subsequent year of assessment. Thus, the taxpayer must, apart from showing that he has an unconditional obligation to perform under a contract, also show that the incurral of the future expenditure can be reasonably expected.

*IN 78* states that when the taxpayer's performance under a contract is unconditional, but is dependent on the customer taking action, the obligation to perform remains unconditional. However, the probability that the customer will take action must be considered.

#### **5.3.1.2.1 The probability that the customer will take action**

According to *IN 78*, a taxpayer might have a legal obligation to perform under a contract, but at a certain point in time, the Commissioner might no longer be satisfied that the obligation will ever be performed. *IN 78* uses gift vouchers as an example. If a taxpayer receives income when selling a gift voucher, he has an unconditional obligation to perform in terms of the gift voucher, but the performance is dependent on the customer redeeming the gift voucher. According to *IN 78*, historical data can show, for example, that if a gift voucher is not redeemed in two years it will never be redeemed. In such circumstances,

the Commissioner will, after two years, not be satisfied that it is *probable* that the taxpayer will incur future expenditure and, therefore, the section 24C allowance will not be allowed again. In the event that the incurral of the future expenditure is not probable, the required degree of certainty that the expenditure will be incurred will, accordingly, also not be met.

The concept of *probability*, with specific reference to the probability that the customer will take action, is thus a new indicator, not previously discussed in this assignment, which can serve to demonstrate whether the taxpayer will perform his obligation under the contract and whether the related future expenditure will be incurred. It is, however, submitted that the probability that expenditure will be incurred can only be considered once it has been established that there is an unconditional obligation to perform under a contract. As shown in chapter 4.2.6, the taxpayer was not allowed to use historical data to determine the probability that a *conditional* obligation would realise and, thereby, argue that it was probable that the expenditure would be incurred in a subsequent year of assessment.

#### **5.3.1.3 Certainty**

From 5.3.1.1 and 5.3.1.2 it is concluded that, when a taxpayer can prove that he has an unconditional obligation to perform under the contract (performance is inevitable), and it is reasonably expected that he will perform under the contract (performance is probable), there will be *certainty* regarding the performance and the related incurral of future expenditure.

#### **5.3.1.4 High degree**

*IN 78* states that there must be a *high degree* of probability and inevitability and a *high degree* of certainty that the expenditure will be incurred in a subsequent year of assessment. Exactly what is meant by *high degree*, and how it should be measured, are not elaborated on in *IN 78*.

It is argued that, in the context of section 24C, 'a degree of certainty' can, *inter alia*, refer to the level of confidence that a taxpayer or the Commissioner has that the expenditure will be incurred in a subsequent year of assessment. A 'high degree' will accordingly refer to a high level of confidence that the expenditure will be incurred in a subsequent year of assessment. It is, however, argued that the measurement of this 'high degree' can easily

become subjective and, therefore, objective guidance to determine when a *high degree* will be obtained, should be provided by SARS.

It is, accordingly, suggested that *IN 78* should expand on what is meant by a 'high degree' and how it will be measured.

### **5.3.2 Potential contractual obligation to perform under the contract**

The question arises whether the reference in *IN 78* to a *potential contractual obligation* to perform under a contract is similar to, or different from, a conditional obligation to perform under a contract, as described in chapter 3.4.1.

*IN 78*, paragraph 4.2.1(b), uses the following two phrases to indicate when a taxpayer will not be able satisfy the Commissioner that the future expenditure will be incurred:

- a performance that is *potentially contractually obligatory*;
- a performance that is dependent on *further events which may or may not occur*. This is described in chapter 3.4.1 as a conditional obligation under a contract.

*IN 78*, paragraph 4.2.1(b), indicates that a taxpayer will be able to satisfy the Commissioner that the future expenditure will be incurred if:

- the taxpayer's performance under a contract is obligatory, although dependent on the client taking action. This will indicate that the degree of certainty required to satisfy the Commissioner that the expenditure will be incurred, does exist.
- the costs will flow from *an unconditional obligation to perform* under the contract which gave rise to the advance income and the Commissioner is satisfied that the expenditure will be incurred in a subsequent year of assessment.

It is, accordingly, submitted that if a taxpayer's performance is only *potentially contractually obligatory*, it means the same as when a taxpayer only has a *conditional obligation* to perform under a contract. This is opposed to *an unconditional obligation to perform under the contract* referred to in *IN 78*. In chapter 3.4.1 it was established that an unconditional obligation to perform under a contract is an indicator that there is certainty that future expenditure will be incurred.

It is, however, suggested that, in order to avoid confusion, *IN 78* should rather refer to a *conditional obligation to perform under a contract*, than to a taxpayer's performance that is only *potentially contractually obligatory*. The use of the phrase *conditional obligation to perform under a contract* will be more consistent with the reference in *IN 78* to its opposite, namely an unconditional obligation to perform under a contract.

#### 5.4 Interplay between trading stock and section 24C

Paragraphs 4.2.3, 4.2.5 and 7.1 of *IN 78* make it clear that SARS is of the opinion that trading stock on hand at the end of the year of assessment, which will be utilised by a taxpayer in a subsequent year of assessment in the performance of his obligation under a contract, will not be included in the section 24C allowance as 'future expenditure'.

As shown in chapter 2.5, Joffe J disallowed the section 24C allowance in *ITC 1739* (refer to chapter 2.5 for a discussion of the facts of the case), because the taxpayer incurred a *loss* as opposed to *expenditure* when using trading stock to replace defective parts which were sold under a warranty to customers<sup>15</sup>. However, JutaLaw provided an evaluative commentary on *ITC 1739* (Case no. 10723). JutaLaw stated that the cost incurred by the taxpayer to manufacture the trading stock represented *expenditure*. Section 22(1), however, provides that the value of closing trading stock at year end must be included in the calculation of the taxable income of the taxpayer. Therefore, the expenditure regarding closing trading stock is effectively not yet deducted for tax purposes at the end of the year of assessment. According to JutaLaw, based on the aforementioned, there is scope for a view that when the manufacturer uses this trading stock to meet his warranty obligation in a subsequent year of assessment, he will incur 'future expenditure'.

Although *ITC 1739* was applicable to a *conditional* obligation to perform under a contract, and the section 24C allowance was therefore correctly not allowed, a valid question that arises from JutaLaw's comments is: Can trading stock on hand at the end of the year of assessment, which will be utilised by a taxpayer in a subsequent year of assessment in the performance of his *unconditional* obligation under the contract, be included as 'future expenditure', in terms of section 24C?

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<sup>15</sup> It has already been established in chapter 3.4.2 that if the taxpayer's performance under a warranty contact is conditional, the section 24C allowance will not be allowed.

An example of a situation where this question will be relevant is when a taxpayer sells gift vouchers, which is redeemable for goods (trading stock) in his store. The taxpayer receives the income in advance and has an unconditional obligation to perform his obligation under the gift voucher contract, by providing the client who is redeeming the voucher, with trading stock. The client can either redeem the gift voucher in the year during which the gift voucher was purchased or in a subsequent year of assessment. If he redeems the gift voucher in a subsequent year of assessment, he can either redeem it out of trading stock that was acquired in the subsequent year of assessment or out of trading stock that was already acquired at the end of the previous year of assessment. The application of section 24C to the latter, must, in the light of the aforementioned question, be considered.

The aforementioned question will be evaluated based on this assignment's established interpretation of section 24C, as well as with reference to the provisions that regulate the deduction of trading stock.

#### **5.4.1 Future expenditure that will be incurred**

Section 24C(1) defines 'future expenditure' in relation to any year of assessment. With specific reference to section 24C(1)(a), a taxpayer must satisfy the Commissioner that:

- the *incurral* of the expenditure will be *after* the end of the year of assessment in which income was received by or accrued to the taxpayer in terms of the contract, as shown in chapter 2.3.1 (section 24C(1)), and
- the amount will be allowed as a deduction from income in a subsequent year of assessment (section 24C(1)(a)).

Based on this assignment's established interpretation of section 24C, it is clear that although trading stock represents 'expenditure' (chapter 2.5), the trading stock on hand at the end of the year of assessment will not meet all the other the requirements of section 24C(1). This is because the expenditure for the trading stock is already actually incurred at the end of the year of assessment. *Actually incurred* implies that the taxpayer has already paid for the trading stock or has an unconditional legal obligation to pay for the trading stock (refer to chapter 2.6 for a discussion of *actually incurred*). Therefore, the

incurral of the expenditure cannot be *after* the end of the year of assessment in which income was received by or accrued to the taxpayer in terms of the contract, as required by section 24C(1). The amount, therefore, does not represent 'future expenditure'. This is in agreement with SARS's interpretation in paragraph 4.2.3, 4.2.5 and 7.1 of *IN 78*.

Paragraph 7.1 of *IN 78* specifically states that, when determining the amount of the section 24C allowance, it should be assessed whether any cost or income should be excluded from the section 24C allowance. *IN 78* lists, for example, depreciation and finance costs and it specifically states that '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' (SARS, 2014(3):25).

Example 10 of *IN 78* refers to gift vouchers redeemable at a homeware department. This example explains the fact that certain costs must be excluded when calculating the section 24C allowance for future expenditure. However, *IN 78* does not indicate, how a taxpayer will know at the end of the year of assessment whether a customer redeeming a voucher in a subsequent year of assessment will draw from trading stock on hand at the end of such year of assessment, or trading stock that will only be acquired in the subsequent year of assessment. The cost of the former must, according to paragraph 7.1 of *IN 78*, be excluded from 'future expenditure', while the cost of the latter can be included. It is suggested that example 10 be expanded to provide further assistance in this regard.

#### **5.4.2 Trading stock**

Although it is correct to say that trading stock on hand at the end of the year of assessment, which will be utilised by a taxpayer in a subsequent year of assessment in the performance of his *unconditional* obligation under a contract, cannot be included as 'future expenditure', there is, however, an anomaly that arises. The anomaly can be explained as follows with reference to the provisions that regulate trading stock:

- The expenditure for the trading stock at hand at the end of the year of assessment is already actually incurred and, therefore, deductible under section 11(a), provided it meets all the requirements of section 11(a).
- However, due to the working of section 22(1), which requires the taxpayer to take the value of the trading stock, not disposed of at the end of the year of assessment, into

account in the calculation of his taxable income, the taxpayer has not yet received an actual tax deduction for the expenditure actually incurred.

- The taxpayer will also not be allowed a section 24C allowance, because the expenditure will not meet the requirement of section 24C(1).
- The anomaly: The taxpayer has, therefore, already received income from the contract, and he is obligated to utilise the trading stock that he acquired in the performance of his obligation under the contract, but he doesn't receive any tax relief for the expenditure actually incurred or in the form of a section 24C(2) deduction.
- The amount of trading stock utilised by the taxpayer in the performance of his obligation under the contract will, however, be allowed as a deduction from income in a subsequent year of assessment, as required by section 24C(1)(a). This is due to the working of section 22(2), which stipulates that the value of the trading stock held and not disposed of at the beginning of the year of assessment is deductible from taxable income.

Example 5.1 further explains the effect that the aforementioned situation has on the normal tax liability of the taxpayer.

### **Example 5.1**

During the current year of assessment ('year one'), the taxpayer, a company, receives R1 000 income from a customer under a contract. The taxpayer is unconditionally obligated to supply, in terms of his obligation under the contract, trading stock to the value of R800 to the customer in the next year of assessment ('year two'). Two scenarios regarding to the acquisition of the trading stock can arise:

#### **Scenario A:**

The taxpayer acquired the R800 trading stock in year one, the same year in which the income was received. He will utilise this trading stock to meet his obligations under the contract in year two. The trading stock is not yet disposed of at the end of year one.

#### **Scenario B:**

The taxpayer will acquire the R800 trading stock in year two to meet his obligations under the contract in year two.

The effect of scenario A on the taxpayer's normal tax liability in year one and year two is as follows:

<b>Scenario A</b>	<b>Year one</b>	<b>Year two</b>
Income		
- Income from contract	1 000	-
- Section 24C(3) allowance	-	-
Section 11(a) deduction:	(800)	-
Section 22(2)	-	(800)
Section 22(1)	800	-
Section 24C allowance (not allowed)*	-	-
Effect on taxable income	1 000	(800)
<b>Effect on normal tax liability (tax at 28%)</b>	<b>280</b>	<b>(224)</b>

\* According to the established interpretation of section 24C, the 'future expenditure' requirement of section 24C(1) will not be met, as the taxpayer *has already incurred* the expenditure for the trading stock in year one.

The effect of scenario B on the taxpayer's normal tax liability in year one and year two is as follows:

<b>Scenario B</b>	<b>Year one</b>	<b>Year two</b>
Income		
- Income from contract	1 000	-
- Section 24C(3) allowance	-	800
Section 11(a) deduction:	-	(800)
Section 22(2)	-	-
Section 22(1)	-	-
Section 24C allowance**	(800)	-
Effect on taxable income	200	-
<b>Effect on normal tax liability (tax at 28%)</b>	<b>56</b>	<b>0</b>

\*\* According to the established interpretation of section 24C, the 'future expenditure' requirement of section 24C(1) will be met, as the taxpayer will incur the expenditure for the trading stock in year two.

### Comparing the effect on the normal tax liability in scenarios A and B:

In scenario A the taxpayer is taxed on the full R1 000 in year one. The income and the deduction are *not matched* in year one and, due to section 22(1), the tax deduction is postponed to year two. In year two, section 22(2) allows for a deduction of the opening trading stock and the effect is that the taxpayer's taxable income and, accordingly, the normal tax liability will be reduced. The net effect of the normal tax liability in year one and year two is R56. It is, however, important to note that the taxpayer is liable for normal tax on the full R1 000 when he receives it, despite the fact that he has already actually incurred expenditure, which will be utilised in the performance of his obligation under the contract.

In scenario B, the income and the future expenditure are *matched* in year one and the taxpayer is, accordingly, liable for normal tax on the profit from the contract in year one. In year two the section 24C allowance is reversed and the section 11(a) deduction is allowed. The net effect on normal tax liability in year two is R0. The net effect of the normal tax liability in year one and year two is R56.

#### 5.4.3 The intention of the Legislator with section 24C

From the *Explanatory Memorandum* on section 24C it seems that the Legislator, with the insertion of section 24C, wanted to address situations where income is received or accrued in terms of a contract in one year of assessment, and the income is to be utilised to finance future expenditure. The *Explanatory Memorandum*, however, further states that 'in a number of instances such advance payments are not *matched* by deductible expenditure, resulting in the full amount of the advance payment being subjected to tax' (SARS, 1980:9).

As shown in 5.4.1, based on the actual wording in section 24C(1), the trading stock on hand which will be utilised by a taxpayer in the performance of his unconditional obligation under a contract in a subsequent year of assessment, does not meet the requirements of section 24C(1). It does, however, seem that the aforementioned trading stock falls within the ambit of the Legislator's original intention with section 24C, namely to provide for an allowance, so that the taxable income can be *matched* with the deductible expenditure.

However, as shown in Example 5.1, scenario A, due to the effect of section 22(1), and the fact that the expenditure is already actually incurred, the taxable income and deductible expenditure are *not matched*, despite the fact that the taxpayer has an unconditional obligation to perform under the contract from which the income was received.

The following two questions arise from the aforementioned:

- Could it have been the Legislator's intention to place the taxpayer who has already incurred expenditure, but has not yet received a deduction, in a less favourable tax position than the taxpayer who is yet to incur the expenditure, as shown in Example 5.1?
- Should the Legislator not amend section 24C in order to clarify the effect that the provisions of sections 22(1) and 22(2) has on the interpretation of section 24C?

These questions will remain unanswered in the assignment. The final Interpretation Note on section 24C will be examined to see whether SARS made any amendments to its interpretation of the interplay between section 24C and trading stock.

## 5.5 Conclusion

Chapter 5 showed that *IN 78* introduced new guidelines, not previously discussed in chapter 2, 3 or 4, relating to the interpretation of section 24C. It was, however, shown that there are shortcomings to the formulation of some of these guidelines.

It is clear from *IN 78* that section 24C only applies to 'expenditure' and not to 'losses'. *IN 78*, however, does not specify whether:

- SARS is of the opinion that fortuitous expenditure or money involuntarily spent is a *loss* and, therefore, not deductible under section 24C or whether it is 'expenditure' and, therefore, deductible under section 24C; and
- A *loss* which can, in certain circumstance, be equated to the word 'expenditure', as was shown by Watermeyer CJ, is deductible under section 24C.

*IN 78* introduces for the first time the phrases *a high degree of probability*, *inevitability* and *certainty* that expenditure will be incurred and a *potential contractual obligation* to perform

under a contract. The question is raised whether these undefined words and phrases might cause confusion when interpreting section 24C. It is suggested that *IN 78* should define these phrases and explain how the *high degree* will be measured.

It was shown that the fact that the incurral of the future expenditure must be *inevitable* is similar to the indicator established in 3.4.1, namely, that the taxpayer must have an unconditional obligation to perform under the contract, if he wants to prove that future expenditure will be incurred.

*IN 78* indicates that the taxpayer must also prove that it is *probable* that the expenditure will be incurred. It was shown that this is a new indicator that will serve to demonstrate that future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract. Historical data can be used to determine the probability that an unconditional obligation will, in fact, be performed and that the related future expenditure will be incurred. When the taxpayer's performance under a contract is dependent on the customer taking action, the obligation to perform remains unconditional. The probability that the customer will take action must, however, be considered.

*IN 78* referred to situations where a taxpayer's performance is only *potentially contractually obligatory*. It was shown that these words are similar to when a taxpayer has a *conditional obligation* to perform under a contract, and that the section 24C allowance will not be allowed in such circumstances. It is suggested, that in order to avoid confusion, the words *potentially contractually obligatory* in *IN 78* should be replaced with 'a taxpayer that has a *conditional obligation* to perform under a contract.

*IN 78* specifically states that trading stock already purchased at the end of a year of assessment and which will be utilised in a subsequent year of assessment in the performance of the taxpayer's obligation under a contract, must be excluded from the section 24C allowance. This is because the expenditure is not 'future expenditure'. It was shown that this interpretation is in agreement with the established interpretation of section 24C, based on the words and phrases used in section 24C. It is, however, questioned whether the established interpretation of section 24C, is in agreement with the Legislator's original intention with section 24C, namely, to match income received under a contract with the related deductible expenditure. It was also asked whether the Legislator should

not amend section 24C in order to clarify the effect that the provisions of sections 22(1) and 22(2) has on the interpretation of section 24C?

## CHAPTER 6: CONCLUSION

Section 24C provides for a deduction of future expenditure that will be incurred by the taxpayer in the performance of his obligations under a contract from which the taxpayer derived income.

Due to some uncertainties that exist regarding the meaning of certain words and phrases used in section 24C, the aim of this assignment was to determine the meaning of the word 'expenditure' and the phrase 'will be incurred' as used in section 24C. Further, in order to establish how a taxpayer will be able to prove that he will incur future expenditure in the performance of his obligations under a contract, the effect of contractual terms and other circumstances on the certainty that future expenditure will be incurred in such a manner, were investigated. Lastly, this assignment discussed certain additional guidelines provided for in *IN 78*, regarding the aforementioned research goals.

It was established that in the context of section 24C the word 'expenditure' means the amount of money spent, including the disbursement of other assets with a monetary value. The word 'expenditure' will include *inter alia* a voluntary payment of money by the taxpayer and the voluntary disbursement of the taxpayer's assets. It was shown that the word 'expenditure' can include a *loss* if the word 'loss' can be equated to the word 'expenditure'.

The phrase 'will be incurred' implies that the taxpayer will, in a subsequent year of assessment, have an unconditional obligation to pay for expenditure, which will arise from the taxpayer's obligations to perform in terms of the contract.

It was established that if there is *certainty* that the taxpayer will perform his obligations under the contract, it will indicate that there is certainty regarding the incurral of the related future expenditure. It was further shown that each *indivisible performance* that the taxpayer must render to fulfill the obligations created by the contract, must be identified to determine whether it will lead to the incurral of the future expenditure.

Contractual terms regulate the performance of the contracting parties. Conditions and warranties are contractual terms that indicate that there is uncertainty regarding the taxpayer's obligations to perform under the contract. The absence of conditions or

warranties in a contract, or, the inclusion of a time clause in a contract can indicate that there is certainty regarding the taxpayer's obligations to perform under the contract.

Certain other circumstances that can indicate whether there is certainty that the future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract were identified. It was shown that a *definite connection* must exist between the incurral of future expenditure and the taxpayer's obligations to perform under the contract.

A distinction must be made between a contingent liability that is not deductible in terms of section 11(a) and a conditional obligation to perform under a contract. Only the latter should be taken into consideration when determining whether future expenditure will be incurred by the taxpayer in the performance of his obligations under the contract.

Unquantified future expenditure that will be incurred in terms of a contract, will not indicate that the incurral of the future expenditure is uncertain. An estimate of the amount of future expenditure that will be incurred must be based on fair and reasonable grounds.

The specific terms of maintenance and repair contracts should be carefully read to determine whether the taxpayer is unconditionally obligated to maintain and repair certain assets or whether the contract contains both conditional and unconditional obligations to repair or maintain an asset.

A taxpayer cannot group similar contracts with similar conditional obligations to perform together in order to determine the probability, and thus the certainty that future expenditure will be incurred in the performance of the taxpayer's obligations under a contract.

*IN 78* showed that in order to attain the required degree of *certainty*, the taxpayer must also be able to prove the *probability* that he will perform the unconditional obligation under the contract. The *probability* of the taxpayer's performance can be determined with reference to historical data.

Although *IN 78* provides additional guidelines which address this assignment's research goals, some shortcomings to these new guidelines were identified. *IN 78* does not specify whether fortuitous expenditure or money involuntarily spent is a *loss* or 'expenditure'. It also does not indicate whether a *loss* which can, in certain circumstances, be equated to

the word 'expenditure', is deductible under section 24C. It is suggested that *IN 78* needs to be amended to provide clarity in this regard.

*IN 78* states that the Commissioner must be satisfied that there is a *high degree of probability and inevitability*, as well as a *high degree* of certainty that the expenditure will be incurred by the taxpayer. These phrases are, however, not defined in *IN 78*, and the question was raised whether these undefined phrases might cause confusion when interpreting section 24C. It is suggested that *IN 78* should define these phrases and explain how the *high degree* will be measured.

*IN 78* refers to the situation where a taxpayer's performance is only *potentially contractually obligatory*. It was shown that this is similar to when a taxpayer has a *conditional obligation* to perform under a contract. It is, however, suggested that the words *potentially contractually obligatory* as used in *IN 78* should be replaced with 'a taxpayer that has a *conditional obligation* to perform under a contract'.

Lastly, an anomaly occurs regarding trading stock at hand at the end of a year of assessment, which will be utilised in a subsequent year of assessment in the performance of the taxpayer's obligation under a contract. Such trading stock does not represent 'future expenditure' and must be excluded from the section 24C allowance. However, due to the interplay between section 24C and section 22(1), the taxpayer does not receive any tax relief for the expenditure actually incurred to acquire the closing trading stock, in the year in which the trading stock is acquired.

It is questioned whether the established interpretation of section 24C is in agreement with the Legislator's original intention with section 24C, namely, to match income received under a contract with the related deductible expenditure. It is also asked whether the Legislator should not amend section 24C in order to clarify the effect that the provisions of sections 22(1) and 22(2) has on the interpretation of section 24C. It remains to be seen whether SARS will make any amendments to section 24C, in order to accommodate the interplay between section 24C and trading stock.

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*Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste*, 1986 (3) SA 549 (A), 48 SATC 55.

*Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue*, 1936 CPD 241, 8 SATC 13.

*Pyott Ltd v Commissioner for Inland Revenue*, 1945 AD 128, 13 SATC 121.

*R Koster & Son (Pty) Ltd & Another v Commissioner for Inland Revenue*, 1985 (2) SA 831 (A), 47 SATC 23.

*Special Board Decision No. 129*, 23 November 1999, South African Tax Cases.

*Case No. 10723 2003 (1) JTLR 1 (GSpCrt)*.

## **ANNEXURE A: EXTRACTS FROM THE INCOME TAX ACT NO 58 OF 1962**

**24C. Allowance in respect of future expenditure on contracts.** — (1) For the purposes of this section, “**future expenditure**” in relation to any year of assessment means an amount of expenditure which the Commissioner is satisfied will be incurred after the end of such year—

(a) in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment;

or

(b) in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of this Act.

(2) If the income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilized in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under such contract, there shall be deducted in the determination of the taxpayer’s taxable income for such year such allowance (not exceeding the said amount) as the Commissioner may determine, in respect of so much of such future expenditure as in his opinion relates to the said amount.

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