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Tax deductions for future expenses

Taxpayers may deduct an allowance for certain future expenditure in terms of section 24C, despite not having incurred the expenditure yet. At the centre of this provision is a requirement that the future expenditure in respect of which the allowance is deducted must, firstly, be funded from the income that arose from a contract and, secondly, be incurred by the taxpayer in the performance of its obligations under such contract. This article reviews some recent case law where these requirements were considered.

Taxpayers are generally only entitled to deduct expenses in determining their taxable income when they actually incur the expenditure. Section 24C of the Income Tax Act provides an exception to this rule. This article provides a brief overview of the provision and some insights gained from recent judgments.

The basic principles

When the provision was introduced in 1980, its stated purpose was to cater for a scenario where a large advance payment is received by a contractor before work commences. Commercially, the payment enables the contractor to purchase materials and equipment. In the absence of section 24C, the advance payment may partially have to be used to pay tax on it rather than fund the expenditure that it was intended for. Section 24C therefore aims to match the timing of deductions with the inclusion of the advance payment in the taxpayer's income.

The first requirement for a taxpayer to apply section 24C is that its income must include an amount that has been received by or accrued to that taxpayer in terms of a contract. The second requirement is that the taxpayer must use this income, in whole or in part, to finance future expenditure. Lastly, this future expenditure should be incurred by the taxpayer in performance of its obligation under such contract. If all these requirements are met, the taxpayer may deduct an allowance (not exceeding the above-mentioned income) in respect of the future expenditure that relates to the income.

The deduction in terms of section 24C is granted in the form of an allowance that must be reversed in the following tax period. This means that the allowance for the future expenditure will ultimately be replaced by the actual expenditure incurred.

Intricacies relating to the contract

The requirements of section 24C that relate to the contract around which the application of the provision centres have been contentious. This is evident from recent judgments relating to these requirements.

In the Big G Restaurants ('Big G') dispute, the taxpayer was a franchisee that operated a number of Spur and Panarottis restaurants in terms of written franchise agreements concluded with a franchisor. The franchise agreements required that Big G periodically revamp the premises. Big G deducted the cost of future revamps against its income under section 24C against income from sales to customers.

In the Constitutional Court, Madlanga J indicated:

> "On my interpretation, it is a requirement of the section that the contract in terms of which the income that is to finance future expenditure is received or accrues must be the same contract under which the expenditure is incurred. So, there is a requirement of "sameness". But I do not read the sameness requirement to connote that there must, for example, in the case of a written contract, be one piece of paper stipulating for the earning of income and the imposition of future expenditure. Two or more contracts may be so inextricably linked that they may satisfy this requirement."

He concluded that, in the case of Big G, the income-earning contracts (sales to customers) and obligation-imposing contracts (franchise agreement) lacked the necessary correlation for section 24C to apply.

In the Clicks Retailers ('Clicks') dispute, the taxpayer operated a customer loyalty scheme in terms of which it awarded points and vouchers to customers. The vouchers could be used as payment or part payment against future purchases by the customer. Clicks deducted the cost of sales that it expected to incur to honour the vouchers in future under section 24C.

In the Supreme Court of Appeal, both Dlodlo JA and Wallis JA emphasised the fact that the future expenditure should relate to the performance of the taxpayer's obligations under the contract in terms of which the income was received. They held the view that in Clicks' case the expenditure related to future purchases of stock to satisfy obligations that related to a future sale, as opposed to Clicks' performance in terms of the initial sale from which the customer earned the loyalty points.