Maintenance contracts: making commercial sense of section 24C

- ENSafrica
- Ehrhard Furstenburg

The Commissioner of the South African Revenue Service (“**the Commissioner**”) has recently published a Draft Interpretation Note (“**the Draft**”) on the allowance of future expenditure on contracts in terms of section 24C of the Income Tax Act 58 of 1962 (“**the Act**”). In the Draft the Commissioner has taken a firm view on what he regards as “a high degree of probability and inevitability” that expenditure will be incurred, especially with regards to maintenance contracts. The view taken by the Commissioner may very well lead to many taxpayers, particularly vehicle manufacturers, having to reconsider the fine print of their maintenance plans and contracts ultimately resulting in an additional cost burden spilling over to consumers.

Section 24C

Section 24C(2) of the Act provides that:

“If the income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and the Commissioner is satisfied that such amount will be utilised in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of his obligations under such contract, there shall be deducted in the determination of the 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."

Accordingly, section 24C grants an allowance for expenditure to be incurred in a future year of assessment under a contract, when income under that contract is received or accrued in advance.

Before a taxpayer is entitled to a section 24C allowance, the taxpayer must be able to demonstrate:

1. that an amount is included in the taxpayer's income in terms of a contract;
2. to the Commissioner's satisfaction that the above amount will be used wholly or partially to fund expenditure that will be incurred by the taxpayer in the future to fulfil his obligations in terms of the contract; and
3. that the future expenditure will be deductible for income tax purposes.

As regards the first requirement, an amount will constitute gross income in a taxpayer's hands if it meets the requirements of the gross income definition, that is, it constitutes an amount, which is received by the taxpayer or to which the taxpayer is unconditionally entitled, during the year of assessment and which is not of a capital nature.

The second requirement is that the Commissioner must be satisfied that the taxpayer will use the income derived from the contract to incur expenditure in fulfilling its obligations in terms of the contract. The Commissioner therefore has a discretion in this regard.

With regard to the third requirement, the expenditure incurred by a taxpayer in fulfilling its obligations in terms of contracts will be deductible for income tax purposes if it meets the requirements of the general deduction formula contained in section 11(a) read with section 23(g) of the Act, namely it constitutes expenditure or a loss, actually incurred by the taxpayer, in the production of income, not of a capital nature, for purposes of the taxpayer’s trade during the year of assessment.

Vehicle maintenance contracts

Vehicle maintenance contracts relieve consumers of most of the risks of maintaining their vehicles, subject to the payment of a monthly fee. Typically, such maintenance contracts are structured for consumers based on a combination of expected kilometres, vehicle application and the expected cost of providing such a risk-free contract. The contracts will ordinarily include services, replacement of clutches as and when they break, etc. Whereas a warranty provides consumers with “cover” against defective workmanship or material, a maintenance contract is designed to maintain or repair components (including lubricants) which are necessitated due to wear and tear.

If a taxpayer is entitled to claim a section 24C allowance in respect of the fees accruing to it from maintenance contracts during a year of assessment, it will be in a tax neutral position. The neutral effect is achieved through the following:

1. a taxpayer will include in its gross income the total fees accruing to it during the year of assessment in respect of the maintenance contracts;
2. a taxpayer will claim income tax deductions in respect of the expenditure actually incurred during the year of assessment in complying with its obligations in terms of the maintenance contracts; and
3. a taxpayer will claim a section 24C allowance in respect of that portion of the fees accruing to it during the year of assessment which was not expended in the relevant year.

In the event that a taxpayer incurs a loss or earns a profit in respect of a maintenance contract, that loss or profit will be deductible or taxable in the year that it is actually incurred or earned. A profit or loss would only arise on the termination of the contract if the vehicle in question required more or less expenditure than the predetermined repairs and maintenance. The section 24C allowance will therefore ensure that a taxpayer is not subject to tax in the current year of assessment in respect of an amount that will be incurred as an expense in a future year.

The Draft

The Draft determines that the words "will be incurred" indicate that the Commissioner must be satisfied that there is a *high degree of probability and inevitability* that the expenditure will be incurred. A taxpayer must therefore be able to demonstrate that, although the expenditure is contingent at the end of the year of assessment, there is a *high degree of certainty* that the expense will in fact be incurred in a future year.

In this regard, the Draft relies on *ITC 1601 (1995) 58 SATC 172* wherein the court held that: "Counsel for the Commissioner, in my view, correctly contended that the Commissioner will not be satisfied that future expenditure will be incurred where there is only a contingent liability. There must be a clear measure of certainty as to whether the expenditure in contention is quantified or quantifiable."

The Draft goes further and mentions that in circumstances where the performance is not contractually obligatory, but is only *potentially* contractually obligatory due to an act other than just the taxpayer's customer taking action, the degree of certainty required is "unlikely to be met".

In addition, the Draft addresses maintenance contracts specifically and although it mentions that it is not possible to formulate a general rule and each case must be determined on its own merits, it contains a firm statement that the

Commissioner will not be satisfied where maintenance is only required in the event of breakage, as opposed to where certain maintenance must be done at regular intervals.

Commercial reality

The reality is that many manufacturers, especially vehicle manufacturers, provide consumers with maintenance contracts which include regular services, as well as maintenance and replacement or repair of components such as clutches in the event of breakage. This adds value to vehicle users, especially having regard to fleets of vehicles having to cover long distances on poor roads. Not allowing vehicle manufacturers an allowance for future expenditure on these contracts, will lead to manufacturers either having to withdraw maintenance contracts or increase the cost thereof to consumers in order to protect themselves against upfront taxation.

However, the Draft also makes mention of the Commissioner rather performing an analysis at a higher level by taking a number of contracts into consideration, as opposed to considering contract by contract.

It remains to be seen what the effect of such a “higher level analysis” by the Commissioner will be and whether the Commissioner will take cognisance of the commercial and economic effect of disallowing future expenditure on vehicle maintenance contracts, or whether the issue will be adjudicated by the courts.