Ruling on special tax provision spells good news for franchise operators

By Natasha Wilkinson

16 Nov 2017

The modern tax advisor must maintain the balance between ensuring that clients are in full compliance with tax laws, yet remain optimally tax planned. Taxpayers only want to give government the correct taxes due, when it is due. There is a natural tension with Sars whereby it is obligated by law to collect maximum taxes, as quickly as possible.

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This tension plays itself out daily where Sars wants to apply tax-charging sections as widely as possible, but tax-relief sections are mostly interpreted narrowly. Conversely, many taxpayers adopt exactly the opposite approach, by trying to optimise their after-tax position.

In a recent landmark case, the Tax Court upheld that a very special, and mostly under-utilised tax deduction allowed by section 24C of the Income Tax Act, No. 58 of 1962, may be applied to franchisee costs. What makes section 24C so unique is that you can deduct future expenses now, albeit that they are not yet incurred. This provides an incredible tax advantage to taxpayers who are operating a business, as it creates a correct matching between expenses and income.

The ruling in B v Commissioner for the South African Revenue Services (IT14240) [2017] ZATC 3, delivered on 3 November 2017, not only clarifies the correct interpretation of section 24C but also informs franchise operators on how they may declare income as financing for refurbishments. This is good news for all franchise holders in South Africa as it will no doubt assist them in planning their taxes better and stimulate their growth.

Implications for franchisees

The court stressed that there are no hard-and-fast rules that apply across all industries and to all cases when deciding if the provisions of section 24C have been met. However, as far as franchisees are concerned, it is clear that where a franchise agreement sets out an obligation to incur future expenditure, such expenditure may very well fall within the beneficial parameters of section 24C of the Act.

Franchisees are, however, encouraged to always engage the services of a qualified tax attorney to assess the validity of such deductions, especially as this is a matter of legal application and is solely dependent on the provisions of the franchise contract.

Arguments

Sars contested that the deduction should not be allowed for two main reasons:

Firstly, the income deducted was not derived directly from the franchise contract as prescribed by law but rather from the sale of food to customers, being numerous separate and unrelated "contracts" so to speak.

Secondly, the franchise contract stated that all aspects of the refurbishment project to be carried out by the franchisee were "subject to" the prior approval of the franchisor. Since the franchisor could withhold such approval, the franchisee's obligation to incur the expenditure was moot.

In response, the franchisee argued that the franchise contract is in fact the source of their income because, without fulfilling its terms and obligations, they would be unable to operate the business. The contract did not make their obligation to upgrade their franchisees optional.

The ruling

After hearing both parties' arguments, the Tax Court held that, as per ITC 1667, there need not be one physical contract document to give rise to section 24C's benefit. Furthermore, while different parties were involved (the franchisor and the restaurant's customers), the franchisee's agreements with each were "inextricably linked" and "not legally independent and separate".

The income deducted was therefore earned under the same contract as the taxpayer's future expenditure, fulfilling the requirements of section 24C. The court also held that the upgrading of the franchisee's restaurants were not optional.

Accordingly, the court ruled in favour of the franchisee and ordered that the additional assessments raised by Sars for the 2011 to 2014 tax years, being unwarranted, must be set aside.

Background

Section 24C permits the deduction of certain expenses in the current tax year assessment, where those expenses are not yet incurred, on the basis that these expenses will contractually be incurred in future years. Although limited in application, this tax allowance protects businesses from being taxed on earmarked funds that bloat their annual earnings. If Sars allows the deduction, the specified amount is carried over into the new year as income rather than retained earnings. A further section 24C deduction may then be claimed until there is a matching of income and expenses.

Franchisees run a business, such as a restaurant or tyre fitment service, using the proprietary business model dictated under contract by the franchise owner (franchisor). To continue operating, the franchisee must deliver the standard of service prescribed by the franchisor. This includes the contractual obligation to refurbish or upgrade their business assets at reasonable intervals (often at the behest of the franchisor), the cost of which is paid from their income.

In the above case, the franchisee (B), a restaurant owner, had claimed a provisional deduction under section 24C for such refurbishment costs against their 2011 to 2014 company tax assessments on the basis that they were so permitted by section 24C.

In South Africa, all tax practitioners must be registered with the South African Institute of Tax Practitioners (SAIT), or another recognised controlling body, as well as with Sars.

ABOUT THE AUTHOR

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