**PREPAYMENTS – SECTION 23H – SHIFTING GOALPOSTS**

By Johan Kotze, Tax Executive at Shepstone & Wylie Attorneys

21 January 2021

The aim of this article is to turn your attention to the income tax treatment of prepayments so that you are not inadvertent caught, because the recent SCA judgment in the Telkom case[1] has indeed moved the goalposts and may spark SARS' attention.

Or let me rephrase: Where SARS and taxpayers thought the goalposts were.

Let's go back to before 2000:

> In those days an expense, which met the requirement of section 11(a), could simply have been claimed as a deduction when it was incurred. The incurral at least had to be actual and unconditional.
>
> The taxpayer was entitled to claim the deduction irrespective whether the amount was paid, or the goods or services were delivered / rendered.
>
> Section 11(a) therefore gave taxpayer a useful tax saving tool, although the liability sat in the taxpayer's deferred tax, the cash was preserved.

Section 23H was then introduced to address this tax *avoidance* scheme (as described by the Explanatory Memorandum). Optically, section 23H strives to create matching in income tax, similar to matching in accounting.

The concept '*actually (unconditionally) incurred*' was no longer stand-alone, with legal precedent to define it, but had to be read with section 23H.

Broadly, the effective consequence of section 23H is that an amount is only allowed as a deduction in a year of assessment to the extent that the underlying goods are supplied, the underlying services are rendered or the person's entitlement to other benefits.

[1] 82 SATC 225

**Basics**

Section 23H does not apply to any trading stock, but applies to any other amounts that are deductible under:

- Section 11(a) – The general deduction formula
- Section 11(c) – Legal fees
- Section 11(d) – Repairs and maintenance
- Section 11(w) – Key-person insurance policies
- Section 11A – Expenses incurred prior to commencement of trade

Section 23H further only applies to expenditure incurred, in respect of:

- goods[2], all of which have not been supplied during the year of assessment in which the expenditure was incurred,
- services, all of which have not been rendered during the year of assessment in which the expenditure was incurred, *or*[3]
- any other benefit, the period to which the expenditure relates extends beyond such year of assessment.

Section 23H is <u>not</u> applicable to:

- where all the goods or services are to be supplied or rendered, or the benefit will be enjoyed, within six months after the end of the year of assessment during which the expenditure was incurred[4],
- where the aggregate of all amounts of expenditure incurred by such person is not exceeding R100 000, which is otherwise limited by section 23H;
- to any expenditure to which the provisions of section 24K[5] or 24L[6] apply; or

[2] I cannot see where '*goods*' will really come into the picture, because trading stock and goods of a capital nature are excluded.
[3] Section 23H(1)(b) use the conjunction '*or*' between '*goods or services*' and '*any other benefit*', but the SCA judgment in Telkom case has in my opinion changed the '*or*' to a '*and/or*'. It also means that the '*in respect of*' does not stand exclusively in direct causal relationship with the *'goods or services … or any other benefit*'.
[4] Unless the expenditure is allowed in terms of section 11D(2)

- any expenditure imposed by legislation.

Section 23H's apportionment is as follows:

- Where expenditure relates to goods, the portion of the expenditure which can be deducted, would be so much of the expenditure as relates to the goods actually supplied to such person in such year of assessment.
- Where expenditure relates to services, the portion of the expenditure which can be deducted, would be:

$$\text{Total expenditure} \times \frac{\text{The number of months in such year during which the services are rendered}}{\text{Total number of months during which the services will be rendered}}$$

- Where the expenditure relates to any other benefit, the portion of the expenditure which can be deducted, would be:

$$\text{Total expenditure} \times \frac{\text{The number of months in such year during which the benefit will be enjoyed}}{\text{Total number of months during which the benefit will be enjoyed}}$$

Where the period of such services or benefit is not determinable, the period is then such period over which the service or benefit is likely to be enjoyed:

If the above apportionment does not represent a fair apportionment, the taxpayer can apply an alternative apportionment that is fair and reasonable.[7]

If it can be shown by the taxpayer that the goods will never be received, the services will never be rendered or the other benefit will never be enjoyed, the unclaimed expenditure, actual paid, can be claimed as a deduction.

[5] Incurral and accrual of amounts in respect of interest rate agreements
[6] Incurral and accrual of amounts in respect of option contracts
[7] Prior to 2015's amendment of section 23H the alternative apportionment was subject to SARS' satisfaction, and SARS had to be approach for a ruling in this regard.

**Telkom case**

Telkom paid cash incentive bonuses to dealers for the connection of initial subscriber contracts in respect of a special tariff plan.

The dispute related to connections that Velociti made to Telkom Mobile, which Telkom contends were cash incentive bonuses for every subscription which Velociti made on behalf of Telkom Mobile.

In the Tax Court Davis J held that the benefit that was attached to the expenditure was the conclusion of the contract with the customer in question. Velociti rendered all the services which it was obliged to do in terms of the incentive letters and received the payment of R178 million. As a result, there was no basis to add back and disallow any portion of the cash incentive bonus expenditure in terms of section 23H.

In the Supreme Court of Appeal Swain JA overturned the Davis' tax court judgment.

The once-off incentive bonus was paid for each new connection (contract) effected by Velociti and the connections were to have been made prior to 30 September 2011, being the date on which the dispensation ended. Therefore, as contended by Telkom, the benefit that was attached to the payment of the cash incentive bonuses related to the new contracts that were concluded.

Telkom argued that it paid a separate commission for the benefit that it derived from the subscription fees, over the term of the subscription agreement, being 24 months; this ongoing commission was separate and apart from the dealer incentive bonuses, payable on the conclusion of the contract. On this basis Telkom submitted that the purpose of the payment of the dealer incentive bonus was to ensure the connection of new customers and the benefit to Telkom was the connection of the new customer. The subscription fees over the term of the subscription agreement were for a separate benefit, in respect of which Telkom paid a separate commission for that benefit.

Sound reasonable?

SARS, however, submitted that the key question was when and how the benefit, in respect of which the expenditure was incurred, was enjoyed. This was because the pleaded dispute turned on, when and how Telkom enjoyed the benefit it received from the cash incentive bonus payment. SARS pleaded that it was the subscription agreement with the client that was the

source of the direct benefit to Telkom. SARS also pleaded that the benefit to Telkom, flowed primarily and directly from the service contract, in terms of which the individual customer paid monthly subscription fees. The dealer was a mere facilitator, who brought about the source of the benefits, and the benefits, *i.e.* the fees, were direct and central to Telkom's business. It was the agreement concluded between Telkom and the respective dealers that was the indirect source of the benefit.

The SCA accepted SARS' argument that the period to which the expenditure '*relates*', must be the period during which the benefit is enjoyed. Telkom did not incur the incentive bonus expenditure solely to establish a new connection with a customer. The benefit laid in having a customer who pays subscription fees over the fixed term of the contract. Telkom did not enjoy any benefit immediately upon the conclusion of a new contract. It has nothing to show for it until such time as the connection turned into fee income. That is when Telkom began to enjoy the true benefits of the cash incentive payments.

We can analyse the Telkom judgment, but when the SCA focused on what the benefit *relates* to, instead of what the payment was *in respect of*, it moved the focus of the causal connection of section 23H, and thereby moved the goalposts. This is unfortunately now part of our tax legal landscape and other courts will no doubt follow this approach.

**SARS' conduct**

It is evident from several private binding rulings that SARS issued dealing with section 23H that they focused on the direct causal connection between the payment and *'goods or services … or any other benefit*', and has also respected the exclusiveness of the *'or*' separating the goods, the services and the other benefits.

I cannot see that SARS will follow the same approach as before, and will no doubt, armed with the Telkom decision, focus on *'any other benefit'*. Without the stretch of imagination, a payment, which is in respect of a service to be rendered in a current year, can easily relate to some remote benefit that will relate to following years of assessment.

One can also expect SARS to start focusing their audits on section 23H, because it is a low-hanging fruit and can result in easy adjustments.

**Taxpayers' heed**

Taxpayers should start thinking carefully about section 23H, and would not want to get in a debate with SARS, because the odds can favour SARS.

Taxpayers often ignore the width of section 23H's ambit, *e.g*. legal fees and repairs and maintenance.

The Telkom case is testimony that a taxpayer should not only focus on the direct services in respect of the payment, but also whether there is any other benefit to which it may relate.

Taxpayers should also take note that the apportionment is not from the date of the payment, but from when the service will be rendered, or from when the benefit will be enjoyed.

**Planning opportunity**

All is still not lost!

This is still only a timing difference and the liability is already provided for in a taxpayer's deferred tax, but do not get caught.

In my opinion a taxpayer should spend more attention analysing expenses falling within the ambit of section 23H, and should also focus on the:

- alternative apportionment, and
- situations when the goods, services or other benefit will not be supplied / rendered / enjoyed.

And perhaps also on an annual basis get a tax practitioner's opinion covering the section 23H's analysis, to hedge the taxpayer from understatement penalties.

For any queries on the above, please contact me at jkotze@wylie.co.za or 011 290 2540