

Tax Treatment of Prepaid Expenditure in the Limelight

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The application of section 23H was one of the issues recently considered by the Supreme Court of Appeal (SCA) in the case of *Telkom SA SOC Limited v CSARS* in relation to upfront cash incentive bonuses paid by Telkom to Velocity (Pty) Ltd for facilitating the conclusion of 24-month subscription contracts with customers on Telkom's behalf.

Application of section 23H to prepaid expenditure

From an accounting perspective, a prepaid expense refers to an expense that is incurred in one financial year in respect of an asset that will only be consumed during one or more subsequent financial years, or an expense that relates to a later year than the one in which it was incurred. It is disclosed as an asset on the balance sheet during the financial year in which it is incurred and it is only expensed to the income statement in subsequent financial years to the extent that it is consumed in or applies to such years.

Section 23H of the Income Tax Act, No 58 of 1962 governs the extent of the deduction that may be claimed during any particular year of assessment in respect of prepaid expenditure which otherwise qualifies for a deduction in terms of section 11(a) (the general deduction formula), (d) (repairs), (c) (legal costs) or (w) (key man insurance policies). Its purpose is to limit the amount of the deduction during any particular year of assessment to the extent of the goods supplied, services rendered or other benefits the person will become entitled to during such year of assessment.

In the case of a benefit, the expense is apportioned on a time basis, based upon the number of months over which the benefit will be enjoyed. One of the instances in which section 23H does not apply is if all the goods or services will be supplied to the taxpayer within six months from the end of the year of assessment during which the expenditure is incurred, or if the taxpayer will obtain the full enjoyment of the benefit to which the expenditure relates within such six-month period.

Telkom case

Up to 30 September 2011, Telkom operated a cash incentive bonus scheme in respect of which it paid certain suppliers a once-off incentive bonus for each new 24-month customer contract concluded on its behalf in respect of a particular tariff plan. In addition to and separate from this scheme, Telkom also paid its suppliers a commission over the term of the 24-month contracts for the benefit it derived from the subscription fees.

During its 2012 tax year, Telkom paid R178 788 421 to Velocity as a cash incentive bonus for the total number of customer contracts concluded on its behalf during such year. In its tax calculation for the year, Telkom claimed the full amount as a deduction in terms of the general deduction formula. The South African Revenue Service (SARS) disallowed R136 531 542 as a deduction in terms of section 23H, on the basis that the period to which the expenditure related extended beyond Telkom's 2012 tax year.

The matter went on appeal to the Tax Court which held that the benefit attaching to the cash incentive bonus scheme was the conclusion of the contracts with new customers and that the cash incentive bonuses were not paid by Telkom for services to be rendered by Velocity after the end of its tax year. The Tax Court, therefore, held that the benefit of the cash incentive bonuses did not extend over the 24-month term of the customer contracts and that section 23H did not, accordingly, apply to the cash incentive bonus payments.

On appeal to the SCA, the issue was whether or not the benefit of the cash incentive bonus payments extended over the 24-month term of the customer contracts. In considering the issues, the SCA was first required to determine what the benefit was and, secondly, when and how this benefit was enjoyed by Telkom.

The SCA held that Telkom enjoyed no immediate benefit upon the conclusion of customer contracts in respect of which the cash incentive bonuses were paid. The benefit to Telkom was rather to have customers who pay monthly subscription fees over the 24-month term of their contracts. It was, accordingly, held that Telkom enjoyed the benefit of the cash incentive bonus payments over the 24-month period of the relevant contracts and that SARS was correct in limiting Telkom's expenditure in terms of section 23H. The SCA held that the commission payments made by Telkom over the term of the contracts did not alter the fact that the benefit of the incentive bonus payments (i.e. the monthly income) is enjoyed by it over the term of the contracts. SARS' appeal was, accordingly, upheld by the SCA.

Comment

Corporate taxpayers are specifically required to disclose in their annual ITR14 income tax returns their prepayments for the year, which are then further divided into prepaid expenditure not limited by section 23H and prepaid expenditure limited by section 23H.

We have recently noticed an increased focus by SARS on the application of section 23H to prepayments by corporate taxpayers. SARS typically requests a breakdown of the taxpayer's prepaid expenses which are not limited by section 23H, together with an explanation of the period to which such expenditure relates in order to determine whether the expenditure will be enjoyed within six months of the end of the tax year.

Taxpayers are advised to exercise extra care when applying section 23H to their prepaid expenses as understatement penalties and interest are automatically imposed in the event of any understatement as a result of the incorrect application of section 23H.



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