

**INTERPRETATION NOTE 48 (Issue 3)**

DATE: 5 March 2018

**ACT : INCOME TAX ACT 58 OF 1962**  
**SECTION : SECTION 24**  
**SUBJECT : INSTALMENT CREDIT AGREEMENTS AND DEBTORS' ALLOWANCE**

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***Preamble***

In this Note unless the context indicates otherwise –

- “**debtors’ allowance**” means the allowance granted under section 24(2);
- “**section**” means a section of the Act;
- “**the Act**” means the Income Tax Act 58 of 1962;
- “**VAT**” means value-added tax levied under the VAT Act;
- “**VAT Act**” means the Value-Added Tax Act 89 of 1991; and

- any other word or expression bears the meaning ascribed to it in the Act.

## 1. Purpose

This Note provides guidance on the application and determination of the debtors' allowance granted under section 24(2), as it applies to instalment credit agreements.

## 2. Background

Section 24 has two main purposes.

First, in the context of a disposal by a taxpayer of trading stock under an instalment credit agreement, section 24(1) provides that the whole amount, excluding finance charges, is deemed to be included in the taxpayer's gross income at the time of entering into the agreement. This deemed inclusion prevents any argument that the proceeds under an instalment credit agreement do not accrue because of a delay in transfer of ownership. In ITC 1900<sup>1</sup> the issue was whether the amounts received or accrued in respect of the disposal of 25 immovable properties had to be included in the appellant's gross income in the 2013 or 2014 years of assessment. The court stated that a right to payment in respect of immovable property under the *Lategan* principle<sup>2</sup> vested in the Appellant, and had a value in its hands, as soon as it was in a position to be able to tender transfer to the purchasers under the agreements. The court refused to accept that the accrual took place only upon transfer when payment occurred.

Binns-Ward J stated that –<sup>3</sup>

“the timing of the transfers and actual making of the payments, and the order in which they happen do not, in my judgment, determine when the taxpayer became ‘entitled to payment’ within the meaning of the *Lategan* principle. The taxpayer's entitlement to payment vested at the date of the fulfilment (including fictitious fulfilment in a case in which the purchaser frustrated the actual fulfilment of the condition) of any suspensive conditions to which the agreement was subject, or the date upon which the taxpayer obtained (or, acting reasonably, could have obtained) the statutory permissions necessary to enable it to tender transfer, whichever occurred later. In other words, the entitlement to payment vested in the taxpayer as soon as the contract became enforceable at the instance of either party”.

In the result, however, the actual date of accrual under the *Lategan* principle was academic because the court found that the proceeds were deemed to accrue under section 24(1) on the date of entering into the agreements.

Secondly, section 24(2) provides the Commissioner with the discretion to grant a debtors' allowance to the taxpayer, the object of which in essence is to subject the profit under the instalment credit agreement to tax on a cash-flow basis.

Section 41 of the Taxation Laws Amendment Act 25 of 2015 proposed an amendment to section 24(2). The proposed amendment removes the Commissioner's discretion and replaces it with the debtors allowance calculation set

<sup>1</sup> (2017) 79 SATC 341 (C).

<sup>2</sup> In *WH Lategan v CIR* 1926 CPD 203, 2 SATC 16 the court held that “accrued” meant “to which he has become entitled”. The decision was approved in *CIR v People's Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A), 52 SATC 9.

<sup>3</sup> At 348.

out in a public notice issued by the Commissioner which prescribes the methods that may be used to calculate the gross profit percentage that should be used to determine the debtors' allowance. The proposed amendment is effective from a date determined by the Minister of Finance in the *Gazette*. At the date of publishing this Note, no date has been gazetted by the Minister of Finance and thus the proposed amendment is not yet effective and taxpayers should continue applying the methods prescribed in this Note.

Finance charges must be recognised on a day-to-day basis over the period of an instalment credit agreement with reference to the outstanding balance under section 24J.

This Note does not apply to the allowances granted to township developers under section 24(2), namely, the debtors' allowance and the allowance for contingent development expenditure.

The debtors' allowance does not apply to –

- sales on extended credit in the absence of a condition suspending the passing of ownership;
- sales subject to a resolutive condition, for example, when it is agreed that a sale shall be regarded as cancelled if the purchase price is not paid by a certain date; and
- leases in terms of which the lessee has an option to acquire the goods at the end of the lease. Such an option is not an agreement of sale, but merely confers on the holder the right to enter into such an agreement at an agreed price at a future date.

Section 24 also applies to lay-by agreements of not less than 12 months. Under a lay-by the buyer pays the purchase price over a period while the seller retains possession of the goods until the purchase price is paid in full. Ownership passes to the buyer on the date on which the purchase price is paid in full and the goods are delivered to the buyer.

### 3. The law

#### Section 24

**24. Credit agreements and debtors allowance.**—(1) Subject to the provisions of section 24J, if any taxpayer has entered into any agreement with any other person in respect of any property the effect of which is that, in the case of movable property, the ownership shall pass or, in the case of immovable property, transfer shall be passed from the taxpayer to that other person, upon or after the receipt by the taxpayer of the whole or a certain portion of the amount payable to the taxpayer under the agreement, the whole of that amount shall for the purposes of this Act be deemed to have accrued to the taxpayer on the day on which the agreement was entered into.

(2) In the case of such an agreement in terms of which at least 25 per cent of the said amount payable only becomes due and payable on or after the expiry of a period of not less than 12 months after the date of the said agreement, the Commissioner, taking into consideration any allowance he has made under section 11(j), may make such further allowance as under the special circumstances of the trade of the taxpayer seems to him reasonable, in respect of all amounts which are deemed to have accrued under such agreements but which have not been received at the close of the taxpayer's accounting period: Provided that any allowance so made shall be included as income in the taxpayer's returns for the following year of assessment and shall form part of his income.

### **Section 9(3)(c) of the VAT Act**

(3) Notwithstanding anything in subsection (1) or (2) of this section—

- (a) N/A
- (b) N/A
- (c) where goods are supplied under an instalment credit agreement, that supply shall, subject to the provisions of subsection (2)(b), be deemed to take place at the time the goods are delivered or the time any payment of consideration is received by the supplier in respect of that supply, whichever time is earlier;

### **Section 10(6) of the VAT Act**

(6) For the purposes of this Act, where goods are supplied under an instalment credit agreement, the consideration in money for the supply shall be deemed to be the cash value of that supply.

## **4. Application of the law**

### **4.1 The meaning of “the whole of that amount”**

Section 24 applies when the passing of ownership of movable property or the transfer of immovable property is deferred until the whole or a certain portion of the selling price is received by the taxpayer. In these circumstances, “the whole of that amount” payable to the taxpayer under the agreement for the disposal of trading stock is deemed to be gross income in the hands of the taxpayer on the day on which the agreement is entered into.

Section 24 is subject to section 24J. Accordingly, interest or similar finance charges are not included in the expression “the whole of that amount”, as contained in section 24(1).

In *CIR v Genn & Co (Pty) Ltd*<sup>4</sup> Schreiner JA stated the following in relation to the definition of “gross income”:

“It certainly is not every obtaining of physical control over money or money's worth that constitutes a receipt for the purposes of these provisions. If, for instance, money is obtained and banked by someone as agent or trustee for another, the former has not received it as his income. At the same moment that the borrower is given possession he falls under an obligation to repay. What is borrowed does not become his, except in the sense, irrelevant for present purposes, that if what is borrowed is consumable there is in law a change of ownership in the actual things borrowed.”

<sup>4</sup> 1955 (3) SA 293 (A), 20 SATC 113 at 123.

Similarly, in *Geldenhuis v CIR*<sup>5</sup> Steyn J stated that the words “received by” as used in the definition of “gross income” –

“must mean ‘received by the taxpayer on his own behalf for his own benefit’ ”.

VAT charged by a vendor (taxpayer) under section 7(1)(a) of the VAT Act for the supply of goods or services (so-called “**output tax**” as defined in section 1(1) of that Act), is not received by the taxpayer on the taxpayer’s own behalf for the taxpayer’s own benefit. When VAT is charged by a vendor there is an immediate obligation to pay the amount of the VAT so collected to SARS at a future date. Such payment is effected by setting off any input tax or other allowable deductions and paying the balance to SARS. In these circumstances output tax does not form part of a taxpayer’s “gross income”. Accordingly, the VAT charged by a vendor does not form part of the expression “the whole of that amount”.

For purposes of section 24, the expression “the whole of that amount” therefore refers to the sum of capital instalments excluding both finance charges and VAT.

#### 4.2 Treatment of finance charges

Under section 24J, finance charges are subject to normal tax over the period in which they are earned according to either the “**yield to maturity**” method or the “**alternative method**” as defined in section 24J(1).

#### 4.3 VAT implications

The supply of goods under an “instalment credit agreement” as defined in section 1(1) of the VAT Act is subject to special time and valuation rules under sections 9(3)(c) and 10(6) of the VAT Act respectively. Output tax must be accounted for on the “cash value” received or receivable in respect of the supply (as determined under section 10(6) of the VAT Act read with the definition of “cash value”) in the tax period under section 27 of the VAT Act during which the goods are delivered, or consideration is received [refer to section 9(3)(c)], whichever is the earliest.

#### 4.4 Debtors’ allowance

In the absence of the debtors’ allowance, section 24(1) could result in adverse cash-flow consequences for a taxpayer because the whole amount under the agreement is deemed to accrue up front, while the instalments may be receivable only over an extended period. A taxpayer might, therefore, not have received sufficient cash to settle the normal tax on the gross profit.

Under section 24(1) the debtors’ allowance is granted to taxpayers only in cases in which the passing of ownership of the property sold is subject to a suspensive condition, namely, payment of the whole or a certain portion of the selling price.

In addition, section 24(2) provides that at least 25% of the whole of the amount under the agreement must be due and payable at least 12 months after conclusion of the agreement before the debtors’ allowance may be granted. For this purpose, any deposit payable is regarded as a payment of a portion of the selling price within the first 12 months.

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<sup>5</sup> 1947 (3) SA 256 (C), 14 SATC 419 at 430.

**Example 1 – Determination of whether 25% of the selling price is payable at least 12 months after an instalment credit agreement is entered into**

*Facts:*

On 1 June 2016 XYZ Ltd sold a second-hand stove to C for R1 000 under an instalment credit agreement. A deposit of R400 was payable on signature of the agreement and the remaining R600 was payable in 30 monthly instalments of R20 each, which are due on the first day of each month commencing 1 July 2016. Determine whether the agreement meets the 25% requirement in section 24(2). Ignore finance charges for the purposes of the example.

*Result:*

Before 31 May 2017 (12 months after the agreement was entered into) C is required to pay a deposit of R400 plus 11 instalments of R20 each.

|   |              |
|---|--------------|
|   | R            |
| Selling price   | 1000         |
| Less: Deposit   | (400)        |
| Less: Instalments payable within first 12 months (11 × R20)     | <u>(220)</u> |
| Selling price payable at least 12 months after agreement signed | <u>380</u>   |

Since 38% (R380 / R1000 × 100) of the selling price is payable at least 12 months after the agreement was concluded, the agreement meets the 25% requirement.

Once the amount of the debtors' allowance has been determined under section 24, it is deductible under section 11(x). In ITC 1697<sup>6</sup> the court held that in exercising the discretion under section 24C the Commissioner could not arbitrarily as a matter of practice restrict the allowance to the amount of taxable income from the trade in question. Accordingly the debtors' allowance can create or increase an assessed loss.

Any debtors' allowance claimed in a year of assessment must be added back to the taxpayer's income in the succeeding year of assessment.<sup>7</sup>

The Commissioner reserves the right to limit the debtors' allowance on any particular transaction. This limitation will not be invoked in normal business transactions of a taxpayer, but will be implemented when a transaction is entered into that is not related to normal business activities or when a scheme is entered into to make use of the gross profit element of the debtors' allowance.

#### 4.5 Amount of the debtors' allowance

The amount of the debtors' allowance is based on the gross profit percentage applied on qualifying outstanding debtors at the end of the taxpayer's year of assessment (excluding finance charges and VAT) and reduced by –

- bad debts under section 11(i), and
- any allowance for doubtful debts under section 11(j).

<sup>6</sup> (1999) 63 SATC 146 (N).

<sup>7</sup> Proviso to section 24(2).

The debtors' allowance is thus arrived at by multiplying the amount of the adjusted qualifying outstanding debtors at the end of the year of assessment by the gross profit percentage.

Finance charges and VAT must also be excluded from turnover (sales) and cost of sales in determining the gross profit percentage which is calculated as follows:

$$[(\text{sales} - \text{cost of sales}) / \text{sales}] \times 100 = \text{gross profit percentage}$$

or

$$(\text{gross profit} / \text{sales}) \times 100 = \text{gross profit percentage}$$

The gross profit should include other forms of income such as delivery charges, fees for maintenance contracts and insurance premiums.

#### **4.6 Commissioner's discretion**

The granting of the debtors' allowance is at the discretion of the Commissioner. In practice the Commissioner's discretion will be exercised upon assessment or audit of the case. Taxpayers must ensure that they have the necessary information or documentation on hand to support any debtors' allowance claimed should this be required by SARS.<sup>8</sup>

Under section 3(4)(b) the Commissioner's decision under section 24(2) is subject to objection and appeal. Should the debtors' allowance be denied, the taxpayer is entitled to object and appeal against the Commissioner's decision in accordance with Chapter 9 of the Tax Administration Act 28 of 2011. Under section 102 of the Tax Administration Act, the burden of proving, amongst others, that an amount is deductible rests with the taxpayer.

#### **4.7 Calculation of debtors' allowance on an individual debtor-by-debtor basis**

The purpose of the debtors' allowance is to grant an allowance equal to the gross profit element of the outstanding debtors at the end of each year of assessment.

The manual determination of the allowance on a debtor-by-debtor basis is simple when there is a single debtor or a few debtors. In other words, the specific gross profit percentage applicable to each debtor is applied to that debtor. This method could also be applied when there are numerous instalment debtors and the taxpayer has a sophisticated computer system capable of determining the exact gross profit percentage applicable to each debtor. Such a method would be the most accurate and would be the ideal method most acceptable to SARS.

The example below illustrates the amortisation of finance charges and determination of the debtors' allowance for a single debtor.

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<sup>8</sup> Section 29 of the Tax Administration Act.

**Example 2 – Calculation of debtors' allowance for a single debtor***Facts:*

X Limited sold and delivered a machine held as trading stock which cost R114 000 (VAT inclusive) to its customer on day 1 of the first year of assessment under the following conditions:

|                         |                          |
|-------------------------|--------------------------|
| Selling Price           | R171 000 (VAT inclusive) |
| Interest rate per annum | 15%                      |
| Payment period          | 3 years                  |

Instalment payments of R74 894 are received annually in arrears.

*Result:*

The total of all capital instalments amounts to R224 682 (R74 894 × 3). This amount is dissected as follows:

|  |                |
|--|----------------|
|  | R              |
| Whole amount (capital amount) = $100 / 114 \times R171\ 000$ | 150 000        |
| VAT (output tax) = $14\% \times R150\ 000$                   | 21 000         |
| Finance charges = $R224\ 682 - R171\ 000$                    | <u>53 682</u>  |
| Sum of capital instalments = $R74\ 894 \times 3$             | <u>224 682</u> |

**Amortisation Table**

| Date           | Instalments<br>R | Finance<br>charges<br>R | VAT<br>(output tax)<br>R | Capital<br>repayments<br>R | Capital<br>balance<br>R |
|----------------|------------------|-------------------------|--------------------------|----------------------------|-------------------------|
| Beginning yr 1 |                  |                         |                          |                            | 150 000 [a]             |
| End year 1     | 74 894           | 25 650 [b]              | 6 048 [c]                | 43 196 [d]                 | 106 804 [e]             |
| End year 2     | 74 894           | 18 263                  | 6 955                    | 49 676                     | 57 128                  |
| End year 3     | <u>74 894</u>    | <u>9 769</u>            | <u>7 997</u>             | <u>57 128</u>              | Nil                     |
| Total          | <u>224 682</u>   | <u>53 682</u>           | <u>21 000</u>            | <u>150 000</u>             |                         |

$$[a] = R171\ 000 \times 100 / 114$$

$$[b] = (R150\ 000 \times 114 / 100) \times 15\%; \text{ or } R171\ 000 \times 15\%$$

$$[c] = (R74\ 894 - R25\ 650) \times 14 / 114$$

$$[d] = R74\ 894 - (R25\ 650 + R6\ 048)$$

$$[e] = R150\ 000 - R43\ 196$$

**Note:**

All the instalments are due at least 12 months or more after the date of the agreement. Thus the requirement is met that at least 25% of the amount payable under the agreement must become due and payable at least 12 months after the date of the agreement.

Individual instalments received yearly from the debtor, as indicated under the column "Capital repayments" will not form part of the company's gross income for that particular year of assessment because the whole amount of R150 000 has already been included in the company's gross income in year 1 under section 24(1).

Individual amounts of VAT (output tax) under the column "VAT (output tax)" will not be accounted for separately, since the total VAT output tax of R21 000 has already been accounted for according to section 27 of the VAT Act. Such individual amounts are not regarded as having been received by the company on its own behalf for its own benefit.

Individual amounts of amortised finance charges under the column "Finance charges" will form part of the company's gross income at the end of each relevant year of assessment according to section 24J.

$$\begin{aligned} \text{Gross profit percentage} &= [(R150\,000 - R100\,000) / R150\,000] \times 100 \\ &= 33\frac{1}{3}\% \end{aligned}$$

### Calculation of taxable income of the company for the three years of assessment

| <b>End of first year of assessment</b>                             | R                    |
|--|----------------------|
| Sales (Gross income definition – sections 1(1) and 24)             | 150 000              |
| Cost [section 11(a)] (R114 000 × 100 / 114)                        | (100 000)            |
| Interest accrued (section 24J)                                     | <u>25 650</u>        |
| Taxable income before debtors' allowance under section 24(2)       | 75 650               |
| Debtors' allowance – section 24(2) (R106 804 × 33 $\frac{1}{3}$ %) | <u>(35 601)</u>      |
| <b>Taxable income</b>  | <b><u>40 049</u></b> |
| <br>   |                      |
| <b>End of second year of assessment</b>                            |                      |
| Interest accrued   | 18 263               |
| Add back previous debtors' allowance                               | 35 601               |
| Current debtors' allowance (R57 128 × 33 $\frac{1}{3}$ %)          | <u>(19 043)</u>      |
| <b>Taxable income</b>  | <b><u>34 821</u></b> |
| <br>   |                      |
| <b>End of third year of assessment</b>                             |                      |
| Interest accrued   | 9 769                |
| Add back previous debtors' allowance                               | 19 043               |
| Current debtors' allowance (RNil × 33 $\frac{1}{3}$ %)             | <u>NIL</u>           |
| <b>Taxable income</b>  | <b><u>28 812</u></b> |

## 4.8 Calculation of gross profit percentage on a globular basis

### 4.8.1 Introduction

Not all taxpayers have sophisticated accounting systems capable of handling an individual debtor-by-debtor determination of the gross profit percentage and it is therefore necessary for SARS to accommodate globular methods which involve estimating the applicable gross profit percentage to be applied to the instalment debtors outstanding at the end of a year of assessment (excluding bad and doubtful debts, VAT and finance charges). An important condition for accepting a globular method is that it must be consistently applied. It will be unacceptable to SARS if a taxpayer switches from one method to another simply to exploit the allowance. A switch would have to be made for a very sound reason, such as an upgrade to a computer system capable of determining the gross profit percentage on an individual debtor-by-debtor basis.

#### 4.8.2 The aged-debtors' basis using applicable average gross profit percentages

Apart from the individual debtor-by-debtor basis, another acceptable method is the aged-debtors' basis. Under this method the outstanding debtors at the end of the year of assessment are aged and allocated across the years of assessment to which they arose. The applicable gross profit percentage for each year of assessment is then applied to the debtors that arose during that year of assessment. Unlike the individual debtor-by-debtor basis, this method uses the average gross profit percentage for a year of assessment. It is therefore not as accurate as the individual debtor-by-debtor approach but will be acceptable to SARS.

##### **Example 3 – Calculation of gross profit percentage (GP%) on a globular basis using a year-by-year aged-debtors' method**

*Facts:*

A company's instalment debtors amount to R50 million at the end of its 2017 year of assessment. The sales that gave rise to the debtors were made during the 2014 to 2017 years of assessment. Set out below is an aged analysis of the debts that arose in each year of assessment together with the applicable gross profit percentages for those years.

| Tax year | Outstanding debtors<br>R | GP<br>% |
|----------|--------------------------|---------|
| 2017     | 30 000 000               | 33,6    |
| 2016     | 11 000 000               | 41,2    |
| 2015     | 7 000 000                | 40,1    |
| 2014     | 2 000 000                | 37,8    |

Determine the debtors' allowance for the 2017 year of assessment.

*Result:*

| Tax year | Outstanding debtors<br>R | GP<br>% | Gross profit<br>R |
|----------|--------------------------|---------|-------------------|
| 2017     | 30 000 000               | 33,6    | 10 080 000        |
| 2016     | 11 000 000               | 41,2    | 4 532 000         |
| 2015     | 7 000 000                | 40,1    | 2 807 000         |
| 2014     | <u>2 000 000</u>         | 37,8    | <u>756 000</u>    |
|          | <u>50 000 000</u>        |         | <u>18 175 000</u> |

The debtors' allowance for the 2017 year of assessment is R18 175 000.

#### 4.8.3 The moving-weighted-average method

If aging of the individual debtors is not possible, a taxpayer could use the moving-weighted-average method.

The instalment debtors at the end of the year of assessment would invariably have built up over several years, with the actual gross profit percentage varying from debtor to debtor and from year to year. This variation could be due, for example, to changes in product line, price wars, general competition and changes in input costs. Another factor that needs to be considered is that debtors arising in earlier years will make up a progressively smaller percentage of the outstanding debtors at the end of a year of assessment because they will have repaid a greater proportion of their instalments. The moving-weighted-average method seeks to take account of these

factors. It involves determining a moving-weighted-average percentage based on each year's sales and gross profit while also taking into account the average period of the relevant agreements. The average gross profit percentage is then applied to the total outstanding debtors (excluding bad and doubtful debts, VAT and finance charges). The method is less accurate than the other two methods described above. Its main deficiency is that it assumes that all instalment sale agreements are of equal length. Nevertheless, this method will also be acceptable to SARS provided it is applied on a consistent basis.

**Example 4 – Calculation of gross profit percentage (GP%) on a globular basis using a moving-weighted-average method**

*Facts:*

ABC (Pty) Ltd commenced business in year 1, selling furniture and household appliances under instalment credit agreements over 36 months. Its gross profit and turnover from instalment sales (excluding finance charges and VAT) were as follows:

|        | Gross profit* | Sales   | GP%  |
|--------|---------------|---------|------|
|        | R             | R       |      |
| Year 1 | 10 000        | 100 000 | 10   |
| Year 2 | 15 000        | 200 000 | 7,5  |
| Year 3 | 5 000         | 40 000  | 12,5 |
| Year 4 | 20 000        | 200 000 | 10   |

\*Gross profit excludes finance charges and VAT.

Calculate the gross profit percentage to be applied to qualifying instalment sale debtors (excluding bad, doubtful debts, finance charges and VAT) for years 3 and 4.

*Result:*

*Year 1*

$$\text{GP\%} = \text{R}10\,000 / \text{R}100\,000 \times 100 = 10\%$$

*Year 2*

|        | Gross profit  | Sales          | Weight | Weighted gross profit | Weighted sales |
|--------|---------------|----------------|--------|-----------------------|----------------|
|        | R             | R              |        | R                     | R              |
| Year 1 | 10 000        | 100 000        | 2      | 20 000                | 200 000        |
| Year 2 | <u>15 000</u> | <u>200 000</u> | 3      | <u>45 000</u>         | <u>600 000</u> |
|        | <u>25 000</u> | <u>300 000</u> |        | <u>65 000</u>         | <u>800 000</u> |

$$\text{GP\%} = \text{R}65\,000 / \text{R}800\,000 \times 100 = 8,125\%$$

**Note:** Year 1's figures have been multiplied by 2 (and not 3) to account for the fact that year 1's debtors should have repaid 1/3 of their instalments. (**NB:** This is of course not strictly true because sales would take place throughout the year and debtors would begin paying their instalments during the year in which sales are made. Nevertheless, as long as the method is applied consistently, a fair result should be achieved.)

| Year 3 |               |                |        |                       |                |
|--------|---------------|----------------|--------|-----------------------|----------------|
|        | Gross profit  | Sales          | Weight | Weighted gross profit | Weighted sales |
|        | R             | R              |        | R                     | R              |
| Year 1 | 10 000        | 100 000        | 1      | 10 000                | 100 000        |
| Year 2 | 15 000        | 200 000        | 2      | 30 000                | 400 000        |
| Year 3 | <u>5 000</u>  | <u>40 000</u>  | 3      | <u>15 000</u>         | <u>120 000</u> |
|        | <u>30 000</u> | <u>340 000</u> |        | <u>55 000</u>         | <u>620 000</u> |

GP% = R55 000 / R620 000 × 100 = 8,87%.

**Note:** Year 1's figures receive a weighting of only 1 because 1/3 of year 1's debtors should still be outstanding at the end of year 3. Year 2's figures are weighted by 2 because 2/3 of that year's debtors should still be outstanding at the end of year 3. Year 3's debtors receive a weighting of 3 because it is assumed that no payments have been received from year 3's debtors by the end of year 3 (see note under year 2 on the assumption regarding the receipt of instalments).

It would not be acceptable to use a simple average of percentages, since it results in an inflated percentage, namely  $(10 + 7,5 + 12,5)/3 = 30/3 = 10\%$ . The figure of 10% is unduly inflated by year 3 in which a low level of sales took place at a relatively high mark up.

| Year 4 |               |                |        |                       |                |
|--------|---------------|----------------|--------|-----------------------|----------------|
|        | Gross Profit  | Sales          | Weight | Weighted gross profit | Weighted sales |
|        | R             | R              |        | R                     | R              |
| Year 2 | 15 000        | 200 000        | 1      | 15 000                | 200 000        |
| Year 3 | 5 000         | 40 000         | 2      | 10 000                | 80 000         |
| Year 4 | <u>20 000</u> | <u>200 000</u> | 3      | <u>60 000</u>         | <u>600 000</u> |
|        | <u>40 000</u> | <u>440 000</u> |        | <u>85 000</u>         | <u>880 000</u> |

GP% = R85 000 / R880 000 × 100 = 9,66%

**Note:** In year 4 the gross profit and sales for year 1 are omitted and the figures for year 4 inserted. This treatment is applied because year 1's debtors should, if they pay according to plan, have settled their debts by the end of year 4.

#### 4.8.4 Use of the current year's gross profit percentage

If the taxpayer's gross profit remains constant from year to year it will be acceptable for the taxpayer to use the current year's gross profit percentage provided that the level of variation over the previous year of assessment does not exceed 2%. The 2% variation is not the simple difference between the previous year's percentage and the current year's percentage, but rather the percentage variation over the previous year's percentage.

**Example 5 – Calculation of gross profit percentage (GP%) on a globular basis using the current year’s gross profit percentage**

*Facts:*

A company’s instalment sales last year yielded a gross profit percentage of 10%. The current year’s percentage is 9,9%.

*Result:*

The company may use the current year’s gross profit percentage of 9,9%, since it falls within the range 9,8% and 10,2%. In other words, the acceptable level of variation is  $10\% \times 2\% = 0,2\%$ .

**Note:** The acceptable range is not 8% and 12% as that involves a 20% variation.

**5. Conclusion**

The sale of trading stock under an instalment credit agreement could be subject to section 24(1) which determines that the whole amount should be deemed to be included in gross income at the time that the agreement is entered into. For purposes of section 24, the expression “the whole of that amount” must exclude finance charges and VAT and will therefore be the sum total of capital instalments.

Taxpayers entering into an instalment credit agreement that are subject to section 24(1) may claim a debtors’ allowance if the requirements under section 24(2) are met. The granting of the debtors’ allowance is at the discretion of the Commissioner. Taxpayers must use one of the methods detailed in this Note to calculate the gross profit percentage that should be used to determine the debtors’ allowance. The method chosen must be consistently applied, since SARS will not accept a taxpayer switching between methods in an attempt to exploit the allowance.

**Legal Counsel**

**SOUTH AFRICAN REVENUE SERVICE**

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