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Income tax treatment of the transfer of contingent liabilities during the sale of a business

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A research report submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (specialising in Taxation)

Income tax treatment of the transfer of contingent liabilities during the sale of a business

Abstract

The objective of this report is to analyse the South African income tax consequences of the assumption of contingent liabilities such as leave pay provisions and bonus provisions during the transfer or sale of a business.

This report will consider two methods utilised to transfer contingent liabilities as part of a sale of a business. An analysis of how these two methods have been derived will be performed as part of this report. The report will then consider the income tax implication of the transfer of contingent liabilities under each of the methods. Overall, this report will critically analyse the income tax implications of the assumption of contingent liabilities during the sale of a business.

A business generally consists of assets and liabilities. Businesses are often sold as a single unit although for income tax purposes, a distinction would have to be made on the particular assets sold.[1] The current South African Income Tax Act caters for the income tax implication of selling assets in a business.[2] It however seems to be silent on the income tax implications in instances where liabilities including contingent liabilities are assumed as part of the sale of assets.[3] As a result, the income tax implication is subjected to the general tax principles which sometimes yield uncertainties from a taxpayer's perspective.

In an effort to clarify uncertainties in relation to the income tax implication of the assumption of contingent liabilities as part of the sale of a business, the South African Revenue Service in December 2016 released Interpretation Note 94. This report will, firstly, test the legal nature of Interpretation Notes with specific reference to reliance being placed on such Interpretation Notes in relation to the interpretation of the Income Tax Act. This report will, thereafter, critically

[1] ITC 108 (1928) 3 SATC 343(U)

[2] Intragroup transactions under sections 41-47 of the Income Tax Act 58 of 1962 ('the Act') and the Eighth Schedule to the aforementioned Act.

[3] The term 'contingent liability' was, until recently, not mentioned in the Act. The Taxation Laws Amendment Act, 2017 (Act 17 of 2017) brought the term into the Act. The term, under section 41(10) of the Act, is considered to be a debt actually incurred solely for the purposes of the intra-group relief under sections 41 to 47 of the Act. The deductibility or the taxation thereof of contingent liability has not been specifically considered in the Act.

examine Interpretation Note 94 in order to assess whether or not the aforementioned uncertainties have been addressed.

In conclusion, this report aims to contribute to the understanding of the income tax consequences of the assumption of separately identifiable contingent liabilities as part of the sale of a business.

Key Words: Contingent Liabilities, South Africa, Assumption of Contingent Liability, Sale of Business as a Going Concern, Interpretation Note 94, Leave Pay Provision, Bonus Provision.

Declaration

I declare that this research report is my own unaided work. It is submitted to the Faculty of Commerce, Law and Management, University of the Witwatersrand, Johannesburg, in partial fulfilment of the requirements for the degree of Master of Commerce (Specialising in Taxation). It has not been submitted before for any other degree or examination at any other university.

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Table of terms utilised in the report

Term	Definition
the Act	Income Tax Act, 58 of 1962 (as amended).
the CGT Guide	Comprehensive Guide to Capital Gains Tax.
CIR	Commissioner for Inland Revenue.
Companies Act	Companies Act 71 of 2008.
CSARS	Commissioner for South African Revenue Service.
Eighth Schedule	Eighth Schedule to the Act.
IASB	International Accounting Standards Board.
IAS 37	IAS 37 – Provisions, Contingent Liabilities and Contingent Assets.
IAS 12	IAS 12 – Income taxes.
IAS 19	IAS 19 – Employee benefits (revised 2011).
IFRS	International Financial Reporting Standards.
ITC	Income Tax Case.
SARS	South African Revenue Service.
Transferor	Seller of a business.
Transferee	Purchaser of a business.
the VAT Act	Value-Added Tax Act, 89 of 1991.

Chapter 1: Introduction

A business is generally sold as a single unit to the potential transferee. This business generally consists of specific assets and liabilities including contingent liabilities. This single unit is generally capable of operating on its own and may constitute the income-earning activity of the taxpayer. The type of the particular business or operation will provide an indication of the assets which need to be sold in order to ensure that the business or operation, or a part thereof, can continue to operate as required.[4]

'A liability may be transferred, as part of the sale of business, inter alia by assumption or delegation'.[5] In terms of the Act, there is no specific section that deals with the income tax implication of the transfer of liabilities including contingent liabilities as part of a sale of business.[6] As a result, the income tax consequence thereof is subjected to the general income tax principle which yields some uncertainties for the taxpayer.

In an effort to clarify the income tax implication of the assumption of contingent liabilities, the SARS issued the erstwhile Binding Class Ruling 29 on 10 May 2011. In summary, this ruling dictated that the transferee which assumes contingent liabilities as part of an amalgamation transaction may claim a deduction in respect of the contingent liabilities assumed once these become actually incurred, while the transferor is not entitled to a deduction in respect of these contingent liabilities. The SARS subsequently issued Binding Private Ruling 185, on 11 December 2014, which generally favours the transferee to get a deduction of contingent liabilities once they are incurred. In addition, the SARS has recently released Interpretation Note 94, on 19 December 2016, which provides guidance on the income tax implication of the assumption of contingent liabilities (such as leave pay provisions and bonus provisions).

[4] SARS Interpretation Note 94 2016:2
[5] SARS Interpretation Note 94 2016:2
[6] As outlined above, under section 41(10) of the Act, contingent liability is only considered to be a debt actually incurred solely for the purposes of the intra-group relief under sections 41 to 47 of the Act. The deductibility or the taxation thereof of contingent liability has not been considered in the Act.

Certain matters regarding the income tax implication of the transfer of contingent liabilities have also been taken to court in order to be decided on. Popular amongst these cases is the *Ackermans Ltd v Commissioner for South African Revenue Service* (2010)[7] ('*Ackermans* case'). In this case, the transferor (Ackermans Ltd) was denied the deductibility of the contingent liabilities transferred to transferee (Pepkor Ltd). The court however indicated as *obiter dictum* that there will be no bar to the transferee deducting the contingent liabilities as and when they are incurred.

The judgment in the *Ackermans* case had relied on, amongst others, the wording of the sale agreement between Ackermans Ltd and Pepkor Ltd in arriving at the conclusion. This presupposes that had the agreement been structured under different circumstances to arrive at the same commercial substance, the judgment could have been different.[8]

The aforementioned efforts by the SARS and the *Ackermans* case have demonstrated the importance of understanding the income tax consequence of the transfer of contingent liabilities as well as finding the suitable income tax implication within the confinement of the South African income tax system.

1.2 Objective of the research

1.2.1 The Statement of the Problem

In terms of the *Ackermans* case as well Interpretation Note 94, are the uncertainties around the income tax implication of the assumption of a contingent liability as part of a sale of business addressed, and would a differently structured sale of business agreement have yielded a different income tax implication outcome? It is worth noting that section 41(10) of the Act was recently amended to introduce, among others, that debt includes a

[7] (1) SA (1) SCA, 73 SATC

[8] Emslie & Davis noted in the commentary to the *Ackermans* case that if the business had been sold for a higher price and the transferor at the same time undertook an unconditional obligation to pay an amount to the transferee for taking over its contingent liabilities, the position would have been different. This illustrates yet again how the same commercial result can be attained in different ways, with differing tax consequences. (Emslie & Davis 2012:341).

contingent liability and that a contingent liability is only considered to be a debt actually incurred. This amendment is only applicable for the purposes of the intra-group relief under sections 41 to 47 of the Act and does not deal with the income tax implication of the assumption of a contingent liability as part of a sale of asset outside of the intra-group relief.

This report will seek to address these questions in the context of case law and the Act. Ultimately, this report will provide a critical analysis of the income tax implication of the assumption or transfer of contingent liabilities during the sale of a business in the context of case law and the Act. In addition, it will critically examine Interpretation Note 94.

1.2.2 Sub-problems

A number of sub-problems will be considered in attempting to address the main research problem as detailed above.

The first sub-problem is to establish the meaning of contingent liabilities and its constituents.

The second sub-problem will consider the gross income definition and also look at the requirements for the deduction of expenditure. The General Deduction formula will be looked into. Subsequently, an analysis of why the income tax implication of contingent liabilities seem to yield uncertainties when transferred as part of a sale of a business will be performed.

The third sub-problem will look at how the purchase price should be allocated amongst the various assets transferred as part of the sale of a business. It will consider some of the possible circumstances or methods of how the sale of business agreements are structured with regards to the assumption or transfer of contingent liabilities. The below methods, as inferred from South African literature and case law on the subject will be considered. The origination of these methods will be dealt with in detail later.

- Method one – Purchase price for the net asset. This is typically gross market value of the assets reduced by the face value of the contingent liabilities. The agreement in such a scenario requires that the net asset purchase price (in other words, a reduced purchase price) is paid and contingent liabilities are assumed by the transferee.

- Method two – Separate transactions but one agreement. Under this scenario, the gross market value of the assets are sold separately to the transferee. The transferor is however, in terms of the sale of business agreement, required to pay the transferee in order for the transferee to assume the contingent liabilities. Eventually the net value (gross market value of assets less face value of contingent liabilities) is settled.

The fourth sub-problem will then measure the aforementioned methods against the gross income definition and deductibility criteria in terms of case law and the Act.

The last sub-problem will critically examine Interpretation Note 94 and assess whether or not Interpretation Note 94 issued by the SARS addresses the issue of the income tax implications of contingent liabilities transferred or assumed as part of a sale of a business.

1. 3 Significance of the Study

This report may make a number of important contributions. It may highlight how the specificity of the sale of business agreement can have an impact on the deductibility of contingent liabilities assumed as well as the overall income tax implication. Furthermore, it provides a critical analysis of the income tax implication of the assumption or transfer of contingent liabilities during the sale of a business in the context of case law and the Act.

1.4 Research Methodology

The report has been performed using qualitative approach. It relies on an extensive literature review resulting in a critical analysis of the income tax implications of the assumption of contingent liabilities during the sale of a business. The report also provides insight on how the possible nature of the sale of a business agreement can have an impact on the deductibility of contingent liabilities assumed as part of a sale of a business.

The extensive literature review and analysis will rely on the following sources:

- Statutes;
- Conference papers;
- Articles, including online ones;
- Case law;
- Interpretation Note 94; and
- Books.

1.5 Scope and Limitations

This report is from the perspective that the transferor and transferee are both companies and are incorporated in the Republic of South Africa or companies which have their place of effective management in the Republic of South Africa. The report focuses on companies because most of the South African literature on the subject and the cases taken to courts deal with companies. The purpose is not to deal with all tax issues, such as Value-Added Tax, Securities Transfer Tax, etcetera, that may be relevant to the sale of a business. Furthermore, this report focuses on identifiable contingent liabilities which are separated (in other words, which are not attached) from assets which are separately recognised for tax purposes. This report deals with specific contingent liabilities which are leave pay provisions and bonus provisions. This report also deals with the transfer of assets outside the intra-group relief provisions within sections 41 – 47 of the Act.

1.6 Chapter Outline

In chapter two, contingent liabilities will be defined within the context of IFRS. The aim of this chapter is to analyse how leave pay provision and bonus provision are measured and recognised for accounting purposes.

Chapter three will look at the gross income definition in detail and consider its constituents as follows:

- total amount in cash or otherwise;
- received by or accrued to in favour of; and
- excluding receipts of a capital nature.

The chapter will also consider the requirements necessary for expenditure to be deductible in the determination of taxable income. The following criteria of the General Deduction Formula will be looked at in detail:

- the taxpayer must be carrying on a trade;
- there should be an expenditure or loss;
- that expenditure or loss must have been actually incurred;
- that expenditure or loss must have been incurred in the production of the income; and
- that expenditure or loss must not have been of a capital nature.

The requirements from relevant case law and the Act will be outlined in performing this analysis. Upon an assessment of these requirements, contingent liabilities will then be measured against each of these requirements.

Chapter four will consider the allocation of the purchase price in the sale of a business. The chapter will then consider how contingent liabilities are factored into the determination of the purchase price of a sale of a business. The

aforementioned methods of the assumption of a contingent liability as part of a sale of business will be considered.

The fifth chapter measures the gross income definition and the deductibility criteria, as applicable, against each of the methods mentioned above. Lastly, this chapter will examine whether or not the wording of the agreement can have a bearing on the deductibility of a contingent liability.

Chapter six will critically examine Interpretation Note 94 and assess whether or not Interpretation Note 94 issued by the SARS addresses the issue of the income tax implications (especially deductibility) of contingent liabilities assumed as part of the sale of a business.

The last chapter will collate the findings of the previous chapters and summarise them in order to address the problem statement by analysing the deductibility criteria against the assumption of contingent liabilities, and the income tax implication thereof, during the sale of a business. This chapter will also conclude on the report.

Chapter 2: Contingent Liabilities

In terms of section 30 of the Companies Act, every company is required to prepare its annual financial statements within a period of six months after its financial year end, or such shorter period as may be applicable in order to give the required notice of an annual general meeting as contained in section 6(7) of the Companies Act. The financial statements are required to meet the qualifying criteria with regards to the financial reporting standards as to form, layout and content in relation to the applicable standards - the financial statements are also required to show the company's assets, liabilities, income, expenses and any other prescribed information.[9]

The financial reporting standards are required to be consistent with IFRS of the IASB.[10] IFRS is a set of accounting standards established by the IASB. The overarching aim of IFRS is to provide a global structure for how public companies prepare and disclose their financial information. Therefore, IFRS provides general guidance for the preparation and disclosure of financial statements.

It would follow that contingent liabilities as presented in the accounting records will be measured and recognised against the principles laid down in IFRS. IAS 37 of IFRS deals with liabilities including contingent liabilities. It provides guidance in relation to the accounting and disclosure for all provisions, contingent liabilities and contingent assets subject to certain exclusions.

In terms of IAS 37, a liability is defined as a present obligation as a result of past events and the settlement of that obligation would result in a reduction of the resources of an entity.[11] It is also key to establish the meaning of provisions and contingent liabilities in terms of IAS 37 as this report deals with leave pay provision and bonus provision. IAS 37 defines provisions as liabilities of

[9] Section 29(1) of the Companies Act
[10] Section 29(5) of the Companies Act
[11] IASB IAS 37, 2014:10

uncertain timing or amount. A provision is required to be recognised when, and only when:

- an entity has a present obligation (legal or constructive) as a result of the occurrence of an event in the past;
- it is more likely than not that a reduction of resources embodying economic gains will be required to settle the obligation; and
- a reliable quantification can be made of the amount of the obligation to be settled. IAS 37 notes that it is only in extremely rare cases that a reliable quantification will be impossible.

Secondly, a contingent liability is defined in terms of IAS 37 as:

- a possible obligation that arises from the occurrence of an event in the past and whose existence will be confirmed only by an uncertain future event which is not within the controllable parameters of the entity concerned; or
- a present obligation that comes from an event in the past but it is not recognised from an accounting perspective because:
  - it is not probable that a reduction in resources embodying economic gains will be used to pay that obligation; or
  - the amount of the obligation cannot be estimated with enough reliability.[12]

Furthermore, there is a link between provisions and contingent liabilities, and IAS 37 provides clarity on this link as follows. In general, all provisions are contingent because they are uncertain with regards to the timing or amount. Within IAS 37, however, the term 'contingent' is used for liabilities and assets that are not recognised for accounting purposes because their existence will be

[12] IASB IAS 37, 2014:10

confirmed only by an uncertain future event which is not within the controllable parameters of the entity concerned . In addition, the term 'contingent liability' is generally used for liabilities that are not consistent with the recognition criteria as indicated above.

The term ‘contingent liability’ was, until recently, not mentioned in the Act. The Taxation Laws Amendment Act, 2017[13] brought the term into the Act. The term is referenced twice in Section 41 of the Act as follows:

> **41. General.**–(1) For the purposes of this Part, unless the context otherwise indicates, any word or expression that has been defined in section 1, shall bear the same meaning so defined, and–
> …
> **“debt”** includes any contingent liability
>
> (10) For the purposes of this Part, a contingent liability is deemed to be a debt actually incurred.

It is important to state that the Part referred to above to which the ‘contingent liability’ was recently introduced is Part III of the Act. Part III of the Act only encompasses sections 41 to 47 of the Act. None of the aforementioned sections deals with the gross income definition or the criteria for the deductibility of an expenditure. These are covered under the Preliminary Part and Part I of the Act. It would therefore follow that reference to the term ‘contingent liability’ would not apply to the gross income definition or the deductibility criteria contained in the Act insofar as sections 41 to 47 of the Act are not concerned.

From an income tax perspective, whereas in terms of a liability there is a present obligation, there is a possible obligation with regards to a contingent liability. It was held by Hoexter JA in *Nasionale Pers Bpk v KBI* (1986)[14] that a liability is only actually incurred for income tax purposes when the outcome is certain or known. The finding of the court was that expenditure is ‘actually incurred’ only if there exists a liability to pay the relevant amount and that as the taxpayer’s liability to pay bonuses could only be determined after the end of its

[13] Act No. 17 of 2017
[14] (3) SA 549 (A), 48 SATC 55

year of assessment, it was merely a contingent liability as at the end of the taxpayer's year of assessment.
It is therefore clear that from an income tax perspective, a contingent liability will only have been actually incurred when uncertainties or probability in relation to its outcome is eliminated. As a result, if a transferor of a business had contingent liabilities in its books at the time of the sale of the business, no incurral of expenditure would have occurred. This raises the question of whether or not an expenditure is therefore incurred by the transferor when the contingent liabilities are assumed by the transferee as part of the sale of a business. This question will be addressed in the chapters to follow.

There are various types of contingent liabilities with reference to the assets to which such contingent liabilities relate. In Interpretation Note 94, the SARS indicated that, from the perspective of selling a business from an income tax respect, a difference must be made between contingent liabilities which are:

- Embedded obligation: includable in the asset such that the contingent liabilities are inseparably connected to the asset and, should the asset be sold, must be transferred by the transferor to the transferee under an applicable regulation. This type of contingent liability has an effect with regards to how such asset should be sold and at what price. This type of contingent liability does not represent the purchase price of an asset; and

- Free-Standing obligation: distinctive existing obligations which are separately identifiable and are not includable in an asset that is independently recognised for income tax purposes. The transfer of these free-standing obligations is not required by an applicable regulation. It can be taken out of the sale of business agreement out of. It does not have an impact on the market value of an asset recognised for tax purposes.

This report focuses on contingent liabilities (i.e. leave pay provision and bonus provision) which are distinctively identifiable and are not includable in an asset that is independently recognised for income tax purposes.

Among the contingent liabilities that are typically transferred during the sale of a business are short term employee related provisions. Examples of these are

leave pay provisions, bonus provisions and post-retirement medical aid provisions.[15]

Whereas IAS 37 provides guidance on the accounting and disclosure for all provisions and contingent liabilities, IAS 19 provides guidance on the measurement, accounting and disclosure by employers for employee benefits. As leave pay provision and bonus provision are employee related benefits, it is key to look at the measurement criteria from an IAS 19 perspective.

IAS 19 prescribes four types of employee benefits as follows:

- Short-term employee benefits: These are employee benefits which are generally required to be paid fully within a period of a year after the end of the financial year during which the affected employees provided services to the organisation. Examples of these benefits include wages, salaries and social security contributions, paid leave and paid sick leave, share scheme incentives and annual bonus;

- Post-employment benefits: These are typically related to pensions, post-retirement medical aid contribution and lump sum payments, such as ex-gratia, upon the retirement of an employee;

- Other long-term employee benefits: These are related to long-service awards, leave or disability benefits; and

- Termination benefits: These are benefits paid following the termination of employment.

As outlined above, short-term employee benefits are required to be settled fully within a period of one year after the end of the reporting period that the affected employees provided services to the organisation.[16] Leave pay provision and

[15] SARS Interpretation Note 94 2016:2
[16] IASB IAS 19, 2013:9

bonus provision are specifically mentioned under short-term employee benefit and as result, they belong to that category of employee benefits.

A company is required to raise a liability when an employee has rendered a service in exchange for the related benefits to be settled in the future.[17] In terms of paragraph 11 of IAS 19, when an employee has rendered a service to a company during a financial reporting period, the company shall recognise the undiscounted amount of related benefits which are expected to be settled as consideration for the services provided:

- as a liability (accrued expense), after the deduction of any amounts which have already been paid to the employee. Where the amount already settled is more than the undiscounted amount of the benefits, that entity is permitted to recognise the difference as an asset in its books provided that such overpayment will lead to a reduction in employee benefits to be paid in future.

- as an expense but subject to the permissibility under other IFRS provisions. There are instances where other standards (for example, IAS 2 Inventories and IAS 16 Property, Plant and Equipment) under IFRS require the inclusion of the benefits in the acquisition cost of an asset instead.

In terms of paid absence provision (i.e. leave pay provision), a company shall determine the cost with regards to the accumulated leave as an additional amount that the entity may be required to settle as a result of unused leave days that has accumulated at the end of the financial year.

For bonus provision, a company shall determine the expected cost of profit-sharing and bonus payments under when, and only when:

[17] IASB IAS 19, 2013:1

- the entity has a present legal or constructive obligation, which are typically in terms of the employment agreement, to settle such determined amount following an event in the past; and
- a trusted estimation of that amount can be made. A present obligation would exists where the entity has no convincing alternative but to settle such amounts with respect to the affected employees.

In light of the above, in terms of IAS 19 read in conjunction with IAS 37, short term employee related provisions are measured and recognised when an **employee has provided a service to the company**. In other words, when an employee has already contributed to the income-earning operations of the employer. These short term employee related provisions are purely accounting estimates of what the entity is expected to pay in future subject to certain suspensive conditions such as the employees remaining under the employ of the employer for a certain period of time.[18] Where such suspensive conditions are not met, there will be no outlay of resources by the employer.

[18] *Nasionale Pers Bpk* case *supra*

Chapter 3: Income and Proceeds & Deductibility of Expenditure

In this chapter, the principles of gross income and the General Deduction formula will be dealt with.

Income

Section 1 of the Act defines income as:

> amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II.

In simple terms, income is gross income less exempt income (i.e. income which is not subject to tax).

Gross Income

Gross income is defined in the Act as:

> in relation to any year or period of assessment, means—
> (i) in the case of any resident, the total amount, in cash or otherwise, received by or accrued to or in favour of such resident; or
> …
> during such year or period of assessment, excluding receipts or accruals of capital nature…

From the above, there are three key constituents of this definition which are vital to the requirements of 'gross income'. These are:

- Total amount in cash or non-cash forms;
- Received by or accrued to in favour of; and
- Excluding receipts of a capital nature.

Each of these constituents are important for the purposes of the gross income definition and have been analysed as follows:

Total amount in cash or otherwise

No definition has been provided for in the Act with respect to the word 'amount'. The word has however been a key determinant in a number of cases. In *CIR v People's Stores (Walvis bay) (Pty) Ltd* (1990)[19], Hefer JA in giving the judgment indicated that income, although expressed as an 'amount' in the definition of 'gross income', must not be an actual amount of money but may be 'every form of property earned by the taxpayer, whether corporeal or incorporeal, which has a monetary value . . . including debts and rights of action'.[20] In other terms, if an amount is not capable of being converted into money, it cannot be considered to be an amount for the purposes of the gross income definition.[21]

The case, *CSARS v Brummeria Renaissance (Pty) Ltd & others* (2007)[22] established or reemphasised a lot of the principles in relation to the definition of gross income. This case unequivocally stated that the word 'amount' in the definition of gross income is to be interpreted widely.[23] This case further stressed on the point that whether or not a receipt or accrual in a form other than cash has a monetary value is one of the many ways of determining if such receipt will constitute an amount. It does not mean however that if a receipt or accrual cannot be converted into money, it has no monetary value.[24] The following salient points from the *Brummeria Renaissance (Pty) Ltd & others* case are noted in that regards:

> The definition of gross income includes not only income actually received, but also rights of a non-capital nature which accrued during the relevant year and are capable of being valued in money and that no more is required for an accrual than that the person concerned has become entitled to the right in question.[25] It must be emphasised that income in a form other than money must, in order to qualify for inclusion in the 'gross income', be of such a nature that a value can be attached to it in money. The tax is to be assessed in money on all receipts or accruals having a money value. If it is something

[19] (2) SA 253 353 (AD), 52 SATC 9
[20] 52 SATC 9 at 11
[21] *Lategan v CIR* 1926 CPD 203, *the People's Stores (Walvis Bay) (Pty) Ltd* case *supra* and *CIR v Butcher Bros (Pty) Ltd* 1945 13 SATC 21
[22] JOL 20634 (SCA)
[23] JOL 20634 (SCA) at 10
[24] JOL 20634 (SCA) at 9
[25] JOL 20634 (SCA) at 5 & 6

> which is not money's worth or cannot be turned into money, it is not to be regarded as income.[26]

Where the receipt or accrual is not in cash, such receipt or accrual can only be included in 'gross income' if it is an 'amount' – that is to say, if it has an ascertainable money value in the applicable year of assessment in which the Commissioner seeks to include it in the taxpayer's gross income as receipt or accrual.[27]

Received by or accrued to in favour of

It is settled law that the words 'accrued to' mean that a person has become unconditionally entitled to an amount.[28] Accrual usually precedes receipt, although it is possible that amounts can be received before accrual or without accrual ever occurring, (for example, in the case of a payment being made before it is due). In the case of *CIR v Delfos* (1933),[29] the court held that the Commissioner may not include an amount in gross income in both instances when it is received and when it accrues. Accordingly, an amount is included in gross income at the earlier of receipt or accrual.

Generally, where an amount is not received for one's own benefit, such a receipt is excluded from a taxpayer's gross income as considered in *Geldenhuys v CIR* (1947).[30] This was also in the case of *CSARS v Cape Consumers (Pty) Ltd* (1999),[31] where the court held that amounts held for the benefit of taxpayer's customers did not belong to the taxpayer as the taxpayer had not received such moneys for its benefit. In reaching this conclusion, the court disposed of the arguments in *CIR v Witwatersrand Racing Club Association* (1960),[32] where it was argued that the charities did not have prior entitlement to the money that was collected by the Association. Accordingly the

[26] JOL 20634 (SCA) at 8
[27] Williams 2015:103
[28] *People's Stores (Walvis Bay) (Pty) Ltd* case *supra*
[29] AD 242
[30] (3) SA 256 (C)
[31] (4) SA 1213 (C)
[32] (3) SA 291 (A)

Association was held to have received the income for its own benefit on the basis that it became unconditionally entitled to the amount.

In addition, in a later English case of *The Jewellers Ltd v Inland Revenue Commissioner* (1947)[33] quoted in the *Greases (SA) v CIR* (1951),[34] the court stated that the moneys received were not the taxpayers' moneys at all. This was simply because they belonged to their clients and the clients had the rights to demand those moneys at any time.

These cases reaffirm that it is not merely the physical receipt that brings an amount within the concept of 'receipt' as contemplated in the definition of gross income. As the court found in the *Geldenhuys* case *supra,* the taxpayer must have received it for his or her own benefit.[35] This is key.

Receipts or accruals of a capital nature

In terms of the definition of 'gross income', receipts of a capital nature cannot be included in a taxpayer's gross income. Whilst there are numerous cases that deal with capital or revenue nature of a receipt, a common trend that appears to be evident is that an amount is usually either revenue or capital. It follows that if an amount received is revenue in nature then it is included in 'gross income'. Similarly, to the extent that an amount is capital in nature, it is excluded from 'gross income'.

In *Pyott v CIR* (1945),[36] the court held, with reference to the taxpayer's argument that an amount received could neither be revenue or capital in nature, that it cannot be the case. This was on the basis that an amount which could be non-capital and yet not income was unheard of. In essence, an amount has to be either revenue or capital in nature.

In *Elandsheuwel Farming (Edms) Bpk v SBI* (1978),[37] in ascertaining whether or not the receipt is of a capital nature, it is important to consider whether or not

[33] 2 All E.R. 762
[34] (3) SA 518 (A)
[35] Davis *et al*. 2000: gross income-2
[36] AD 128, 13 SATC 121
[37] 39 SATC 163

the sale amounted to a realisation of a capital asset or a profit-making scheme. The profit-making scheme will be mainly the case where an asset is acquired with the view of reselling it at higher amount than the amount it was acquired for in the first instance. The disposal of an asset which was bought with a view of holding it, either in an unproductive condition or to use it to generate income, and in fact so held, will result in a realisation of fixed capital and the amount received thereof will be an accrual of a capital nature.

The judgment from the aforementioned case goes on to say that in determining whether the sale is a profit-making scheme or a realisation of a capital asset, the intention of the taxpayer needs to be considered. When looking at the intention, one needs to consider both the subjective and objective factors which gave rise to the realisation of the said asset. Objective factors being the measurement of the true facts and circumstances surrounding the transaction, i.e. frequency of transactions, etcetera, are said to outweigh the subjective factors, being a person's own personal plan or agenda, and as such more reliance and importance is placed on objective factors which are said to be free from manipulation.[38]

Proceeds

The definition of proceeds is contained in Part VI of the Eighth Schedule. Paragraph 35 defines proceeds as follows:

> subject to subparagraphs (2), (3) and (4), the proceeds from the disposal of an asset by a person are equal to the amount received by or accrued to, or which is treated as having been received by, or accrued to or in favour of, that person in respect of that disposal, and includes—…

Similar to the definition of gross income, the terms 'the amount' and 'received by or accrued to or in favour of' are key to this definition. These terms have been explained in detail under the gross income definition above and the same explanation will apply with respect to similar terms in the definition of proceeds.

[38] Stiglingh *et al.* 2017:29

The key difference between gross income and proceeds is the nature of the amount i.e. whether such amount is capital or revenue in nature. The CGT Guide indicates that as a general rule, any amount received by or accrued to which is of a revenue nature is gross income. Whereas, receipts or accruals of a capital nature which are not included in gross income would generally relate to the disposal of assets or waiver of debt and will accordingly qualify as proceeds under the Eighth Schedule.[39]

Deductibility of Expenditure

With regards to the deductibility of leave pay provision and bonus provision, three key sections of the Act have to be considered. These sections are as follows:

- 11(*a*) of the Act – General deductions allowed in determination of taxable income;
- 7B of the Act – Timing of accrual and incurral of variable remuneration; and
- 23(*g*) of the Act – Deductions not allowed in determination of taxable income.

Section 11(*a*) of the Act deals with the deductibility of expenditure as follows:

> For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived—
>
> (*a*) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature;

[39] SARS CGT Guide 2013:8

Section 23(*g*) of the Act is to be read in conjunction with section 11(*a*) of the Act when considering whether or not expenditure should be deductible.[40] Section 23(*g*) of the Act states the following:

> No deductions shall in any case be made in respect of the following matters, namely—
>
> *(g)* any moneys, claimed as deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade.

In simple terms, section 23(*g*) of the Act prevents the deduction of moneys that were not used for the purposes of trade.

In terms of section 11(*a*) read together with section 23(*g*), in order for an amount to qualify for a deduction, the following requirements must be met:

- the taxpayer must be carrying on a trade;
- there should be an expenditure or loss;
- that expenditure or loss must have been actually incurred;
- that expenditure or loss must have been incurred in the production of the income; and
- that expenditure or loss must not have been of a capital nature.

Another deductibility criteria exists in terms of the Act for certain expenditure that are termed as variable remuneration. This criteria is contained in section 7B of the Act. Section 7B(2) of the Act deals specifically with variable remuneration as follows:

[40] Stiglingh et al. 2017:139

In determining the taxable income derived by any person during a year of assessment, any amount to which an employee becomes entitled from an employer in respect of variable remuneration is deemed to—

(*a*) accrue to the employee; and
(*b*) constitute expenditure incurred by the employer,

on the date during the year of assessment on which the amount is paid to the employee by the employer.

Variable remuneration is defined in section 7B of the Act as:

(*a*) overtime pay, bonus or commission contemplated in the definition of "remuneration" in paragraph 1 of the Fourth Schedule;

(*b*) an allowance or advance paid in respect of transport expenses as contemplated in section 8(1)(*b*)(ii); or

(*c*) any amount which an employer has during any year of assessment become liable to pay to an employee in consequence of the employee having during such year become entitled to any period of leave which had not been taken by the employee during that year.

Remuneration is also defined in the Act as

any amount of income which is paid or is payable to any person by way of any salary, leave pay, wage, overtime pay, bonus, gratuity, commission, fee, emolument, pension, superannuation allowance, retiring allowance or stipend, whether in case or otherwise and whether or not in respect of services rendered.[41]

Bonus provision would qualify as a variable remuneration as it has specifically been referred to in part (*a*) of the definition of variable remuneration. Leave pay provision will also meet the definition of variable remuneration as it has also specifically been captured under part (*c*) of that definition.

In light of the above, the underlining conditions, in terms of the aforementioned sections for leave pay provision and bonus provision to be deductible in determining a person's taxable income are as follows:

- the taxpayer must be carrying on a trade;

[41] Paragraph 1 of the Fourth Schedule to the Act

- there should be an expenditure or loss;
- that expenditure or loss must have been actually incurred;
- that expenditure or loss must have been incurred in the production of the income;
- that expenditure or loss must not have been of a capital nature; and
- paid by employer to the employee.

The first five bulleted requirements are from the General Deduction formula. The sixth is an additional requirements in terms of section 7B of the Act as outlined above. These six requirements have been analysed below.

The taxpayer must be carrying on a trade

The opening words of section 11 of the Act read as follows: 'For the purpose of determining the taxable income derived by any person **from carrying on any trade**, there shall be allowed as deductions from the income of such person so derived…' (Own emphasis.) It is therefore the pre-condition to the deductibility of all the items in sub-paragraphs (*a*) to (*n*) of section 11 of the Act that the taxpayer must be carrying on a trade. In ITC 697 (1950), the question at issue was whether the taxpayer was entitled to deduct expenditure incurred during the period when the building was being demolished and prior to the erection of a new building. It was held in the negative. Price J in giving the judgment stated the following:[42]

> The question in this case is not whether an income was produced or not, but whether there was in existence a business which was being carried on for the purpose of producing income. It is one thing for a taxpayer to conduct a business for the purpose of producing income and to fail to produce that income, and quite another thing for such a taxpayer to be in the process of equipping an undertaking which he intends to turn into a business for the purpose of producing income. The real question which is involved in this case is whether during the period when the undertaking is being equipped expenditure then incurred, during that period, is expenditure incurred in the production of income or in an attempt to produce income.

[42] 17 SATC 94 at 95

Trade is defined in section 1 of the Act as follows:

> includes every profession, trade, business, employment, calling, occupation or venture, including the letting of any property and the use of or the grant of permission to use any patent as defined in the Patents Act or any design as defined in the Designs Act or any trade mark as defined in the Trade Marks Act or any copyright as defined in the Copyright Act or any other property which is of a similar nature.

Trade must be given the widest possible meaning as laid down in *Burgess v CIR* (1933).[43] Notwithstanding its wide interpretation, the term 'trade' does not include all activities of the taxpayer that might result in the production of income - by way of an example, income in the form of interest, dividends, annuities or pensions earned by the taxpayer will not demonstrate that the taxpayer is trading.[44] Section 11(*a*) of the Act requires expenditure to have been incurred as part of 'carrying on a trade'. Section 23(*g*) of the Act brings in 'for the purposes of trade'. These suggest that there should have been some sort of continuity of activities as confirmed in ITC 1529 (1991).[45] In *Modderfontein Deep Levels Ltd v Feinstein* (1920)[46] Wessels J in the judgment of the court a quo, which was upheld by the Full Court of the Transvaal Provincial Division, indicated that to constitute a business there must be an unequivocal intention to carry on similar acts from time to time as long as the opportunity offers. That acts should be done successively with an intention to carry on trade as opposed to being done once or twice.[47] These cases indicate that there must be some sort of continuity in the taxpayer's trade in order to constitute 'for the purpose of trade or carrying on a trade'. In addition, in ITC 1529 (1991),[48] it was held that there has to be a long-term objective to generate a profit.[49]

In the *Modderfontein Deep Levels Ltd* case *supra,* the court had to consider the meaning of 'carrying on trade or business'. The court ruled that a profit motive is

[43] (4) SA 161 (A), 55 SATC 185 At 196
[44] Stiglingh *et al.* 2017:137
[45] 54 SATC 252 at 254
[46] 1920 TPD 288
[47] 1920 TPD at Page 291
[48] 54 SATC 252 at 259
[49] 54 SATC 252 at 259

not a prerequisite for a taxpayer to trade. Wessels J in delivering the judgment stated the following:[50]

> I do not understand that the Judges intended to lay down that a person cannot carry on the trade or business of dairyman unless he desires to make a profit out of it. The Court was dealing with the case of a man who occasionally sold half a bottle of milk to a friend as a favour but who did not make a practice of selling milk. BRISTOWE, J., said: "I do not think one or two isolated transactions of selling or bartering milk constitute carrying on the trade of dairyman." Although some sentences taken out of the judgments may leave the impression that the Court held that a person cannot carry on a trade unless he intends to make a profit I do not think that this was the view of the Court. What the Court in fact decided was that a person who occasionally sold or bartered half a bottle of milk, but who did not do this with the intention of making a profit, was not carrying on the business or trade of a dairyman. If you find that, there is an intention to make a profit in selling or bartering there is a presumption that a trade or business is being carried on, and if in addition you find that the sales are not one or two isolated transactions but a series then the presumption becomes absolute proof.

It is submitted that in appropriate circumstances a taxpayer will be carrying on a trade even if he has no objective to make a profit, or even if he deliberately sets out to make a loss.[51]

There should be an expenditure or loss

The words ‘expenditure and losses’ have not been defined in the Act. In *Joffe & Co (Pty) Ltd v CIR* (1946),[52] Watermeyer CJ stated that the word ‘loss’ signifies an involuntary deprivation suffered by the loser whereas expenditure signifies a voluntary payment of money.[53]

The word expenditure was also considered in ITC 1783 (2004)[54] wherein the court was called upon to decide whether or not a taxpayer has incurred an expenditure by allotting its shares in discharge of a purchase price during the purchase of a business. The court indicated that:[55]

[50] 1920 TPD 288 at 290 & 291
[51] Stiglingh *et al.* 2017:137
[52] 13 SATC 354
[53] 13 SATC 354 at 360
[54] 66 SATC 373
[55] 66 SATC 373 at 376

> 'Expenditure' in its ordinary dictionary meaning is the spending of money or its equivalent – for example time or labour and a resultant diminution of the assets of the person incurring such expenditure. An allotment or issuing of shares by a company does not in any way reduce the assets of the company although it may reduce the value of the shares held by its shareholders. In these circumstances such issue or allotment of shares does not, in our view, constitute expenditure by the company.

It follows that an expenditure must involve a conscious payments of money or a conscious undertaken of an obligation to pay money. A loss, on the other hand, is an unconscious deprivation.

That expenditure or loss must have been actually incurred

The phrase actually incurred has been considered in a number of cases. In the *Pyott Ltd* case *supra*, the issue at hand was whether the 'provision' made by the taxpayer for amounts which he would have to refund on the return of the tins qualified as a deduction. It was held that the amount in issue was a mere estimate of a contingent liability and was not expenditure 'actually incurred' as required by the Act. The fact that it was in accordance with valid accountancy practice was irrelevant.[56]

Watermeyer AJP in giving his judgment in the case of *Port Elizabeth Electric Tramway Co v CIR* (1936)[57] stated the following:[58]

> But expenses "actually incurred" cannot mean "actually paid." So long as the liability to pay them actually has been incurred they may be deductible… Taking these in turn, the words of the statute are "actually incurred" not "necessarily incurred." The use of the word "actually" as contrasted with the word "necessarily" may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses therefore are not "necessary" but they are actually incurred and therefore deductible.

Where the taxpayer's present legal obligation in respect of expenditure is at the end of the year of assessment not certain in the sense that the obligation is dependent on the occurrence of a future uncertain event, the expenditure will

[56] Williams 2015:425
[57] CPD 241, 8 SATC 13
[58] 8 SATC 13 at 15

not been deemed to have been 'actually incurred' during that year of assessment.

Still on the phrase 'expenditure or loss must have been actually incurred', the following is noted with respect to the case of *CIR v Golden Dumps (Pty) Ltd* (1993) held by Nicholas AJA:[59]

> Full weight had to be accorded to the word 'actually' in the phrase 'actually incurred'. There was no difference in the principle between a case where liability was contingent in the legal sense and one where it was contingent in the popular sense, and a liability was contingent in the latter sense where there was a claim, which was disputed, at any rate genuinely disputed and not vexatiously or frivolously for the purposes of delay. In such a case the ultimate outcome of the situation would be confirmed only if the claim were admitted or finally upheld by the decision of a Court or arbitrator. Where, at the end of the year of assessment in which a deduction had been claimed, the outcome of a dispute was undetermined, it could not be said that a liability had been 'actually incurred'.

In addition, the phrase 'expenditure incurred' was considered in the *Ackermans* case. The court was required to decide whether by virtue of the terms of a sale of business agreement, Ackermans Ltd was entitled to a deduction in respect of certain contingent liabilities taken over by Pepkor Ltd in terms of section 11(*a*) of Act. Cloete JA stated the following:[60]

> It is clear that what occurred, as is usually the case in transactions of this nature, is that the nett asset value of the business - the assets less the liabilities - was calculated and that this valuation dictated the purchase price. In the ordinary course of purchasing the business as a going concern on this basis it would follow that the liabilities would be discharged by the transferee. The journal entries relied on by the appellants do not equate to expenditure actually incurred. On the contrary, the mechanism employed in the agreement of sale resulting in the journal entries was to facilitate the sale. The fact that Ackermans rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, does not mean in fact or in law that it incurred expenditure to the extent that the purchase price was reduced by the liabilities. At the effective date no expenditure was actually incurred by Ackermans.

What is evident in these cases is that in order for the 'actually incurred' criteria to be met, that amount incurred must constitute an unconditional obligation which would result in an outflow of resources.

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[59] (4) SA 110 (A), 55 SATC 198, 1993 Taxpayer 194
[60] 73 SATC 1 at 6

That expenditure or loss must have been incurred in the production of the income

The *locus classicus* on when expenditure will be incurred in the production of income is *Port Elizabeth Electric Tramway Company Ltd* case *supra*.[61]

It was held in the aforementioned case that:[62]

> all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it.

The principles of *Port Elizabeth Electric Tramway Company Ltd* case *supra* was somehow confirmed in the *Sub-Nigel Ltd v CIR* (1948).[63] The case bordered on a taxpayer, a company carrying on the business of gold mining, which had taken out certain insurance policies against loss of profits occasioned by fire and standing charges but had made no claim on the insurer. The Commissioner disallowed the deductions and the taxpayer's appeal to the Special Court was dismissed on the ground that the premiums were not expended wholly and exclusively for the purposes of the taxpayer's trade and that accordingly the deduction thereof was prohibited. On appeal to the Appellate Division, the Commissioner argued that since the policies had never paid out, the expenditure had produced no income and was therefore not incurred in the production of income. HELD by Centlivres JA the following:

> In determining whether expenditure had been incurred in the production of income, it was irrelevant whether the expenditure actually produced income, provided that it was incurred for the purposes of earning income. Any proceeds from the policies in respect of profits and standing charges would have been of a revenue nature and would have been includable in the taxpayer's gross income. The act upon which the payment of premiums was attendant, namely the taking out of the insurance policies, was done for the purpose of earning income in the event of a fire preventing the performance of a normal-producing operations. Accordingly, even though no income was in fact produced by the act of insuring, the premiums paid constituted expenditure incurred in the production of income.

[61] Davis *et al* 2000: 11(a)-15
[62] 8 SATC 13 at 17
[63] 1948 (4) SA 580 (A), 15 SATC 381

It follows that once an expenditure can be attached to the performance of a business operation, that expenditure should be deductible. Further, section 11(*a*) of the Act does not require the expenditure which is claimed as a deduction to have produced income in the same year of assessment, or indeed at all. There is no requirement that the expenditure be 'matched' to income.[64]

That expenditure or loss must not have been of a capital nature

It is often difficult to distinguish between capital and non-capital or 'revenue' expenditure.[65] Broadly speaking, the courts apply four different tests to determine the nature of expenditure.[66] The four tests as indicated by Davis *et al.* are categorized as follows:

1. enduring benefit;
2. once and for all;
3. closeness of connection between the expenditure and the income producing activities; and
4. fixed or floating capital.

These tests have been analysed below.

Enduring benefit

Under the enduring benefit test, the question to be asked is whether the taxpayer obtained an enduring benefit by incurring the expenditure. If the answer is in the affirmative, the expenditure is of a capital nature (*British Insulated and Helsby Cables Ltd v Atherton (HM Inspector of Taxes)* (1926)[67] and *Burman v CIR* (1991)[68].[69]

[64] Williams 2015:449
[65] Stiglingh *et al.* 2017:144
[66] Davis *et al*. 2000: 11(a)-19
[67] AC 205
[68] (1) SA 533 (A), 53 SATC 63
[69] Davis *et al*. 2000: 11(a)-19

Once and for all

Recurrence of expenditure is usually an indication that the expenditure is of a revenue nature (*Vallambrosa Rubber Co v Farmer* (1910)[70]).[71]

Closeness of connection between the expenditure and the income producing activities

The test most frequently used to determine the nature of expenditure is to determine whether the expenditure was more closely connected to the income-producing assets than to the income-producing activities. If it is more closely connected to the former, then it is of a capital nature; if more to the latter, then it is of a revenue nature.[72] Streicher JA confirmed this in *Commissioner for SARS v BP SA (Pty) Ltd* (2006) where it was held that:[73]

> A test that has been adopted to assist in the determination whether expenditure is of a capital or revenue nature is to ask whether the expenditure is more akin to the income producing operations of the taxpayer or whether it is more akin to the income-earning structure of the taxpayer, or to ask 'is it expenditure required to carry on a business or is it required to establish a business?' Money spent in creating an income –producing concern is capital expenditure; it is invested to yield future profit.

Fixed or floating capital

Another test used to determine the nature of expenditure is to determine whether the expenditure relates to fixed or floating capital.[74] Floating capital are generally considered to be revenue in nature whereas fixed capital are generally considered to be capital in nature. Watermeyer CJ indicated in *New State Areas Ltd V CIR* (1946)[75] that[76]:

> When the capital employed in a business is frequently changing its form from money to goods and vice versa (for example, the purchase and sale of stock by a merchant or the purchase of raw material by a manufacturer for the purpose of conversion to a

[70] SC 519
[71] Davis *et al.* 2000:11(a)-20
[72] Davis *et al.* 2000:11(a)-21
[73] JOL 17491 (SCA) at 12
[74] Davis *et al.* 2000:11(a)-24
[75] 14 SATC 155
[76] 14 SATC 155 at 164

> manufactured article) and this is done for the purpose of making a profit, then the capital so employed is floating capital. The expenditure of a capital nature deduction which is prohibited under section 11(2), is expenditure of a fixed capital nature, not expenditure of a floating capital nature, because expenditure which constitutes the use of floating capital for the purpose of earning a profit, such as the purchase price of stock in trade, must necessarily be deducted from the proceeds of the sale of stock in trade in order to arrive at the taxable income derived by the taxpayer from that trade. The problem which arises when deductions are claimed is therefore usually whether the expenditure in question should properly be regarded as part of the cost of performing the income-earning operations or as part of the cost of establishing or improving or adding to the income-earning plant or machinery.

It is worth mentioning that what may be floating capital in the hands of one taxpayer may be fixed capital in the hands of another.[77] In conclusion on the four tests, it is important to note that none of these tests are absolutely conclusive and in most cases a combination of the tests are used.[78]

The amount must be paid to the employee by the employer

Variable remuneration will only qualify as an expenditure incurred by the employer on the date with respect to the year of assessment on which it is paid to the employee by the employer. 'Paid to' is self-explanatory in the sense that there must be an actual payment of an amount to the employee by the employer. The Explanatory Memorandum attendant to the introduction of section 7B of the Act stated that:

> The tax events for these items will be deemed to occur only when the underlying amount is paid by the employer to the employee for purposes of determining: (i) employee gross income, (ii) pay-as-you-earn withholding, and (iii) employer deductions. Mere accruals and incurrals will be disregarded. From a practical perspective, this change should alleviate the need for complex interpretation (thereby reducing the number of unintended SARS-taxpayer disputes) and pay-as-you-earn mismatches without violating the integrity of the tax system overall.

The timing of the accrual and incurral of variable remuneration will therefore be on the payments basis and will therefore only be included in the income of the employee and be taken into account for employees' tax purposes and be expenditure incurred on the date of payment.

[77] Davis *et al.* 2000:11(a)-24A
[78] Davis *et al.* 2000:11(a)-19

Conclusion

The above analysis indicates that in order for leave pay provision and bonus provision to be deductible, the following should generally be met:

- the taxpayer must be carrying on a trade;
- there should be an expenditure or loss;
- that expenditure or loss must have been actually incurred;
- that expenditure or loss must have been incurred in the production of the income;
- that expenditure or loss must not have been of a capital nature; and
- paid by employer to the employee.

These points are fundamental to the analysis to be performed in the remainder of this report.

Chapter 4: Possible nature of agreement

The sale of business agreement is a vital factor in determining the resultant tax implications of the sale in both the transferor's and transferee's hands. The ruling of the *Ackermans* case *supra* provided clarity on how important the agreement between the parties is as it will play an integral part in determining the tax consequences to follow.[79]

The question then arises as to how the sale of business agreement is typically structured. A number of South African literature has considered how the sale of business agreement must be structured in order to navigate through the tax minefield. The sale of business agreement per the *Ackermans* case, which required the transferor to purchase the business at a net price (market value less liabilities), has been advised against by some of the South African literature on the subject.

The sale of business agreement will be typically interpreted on the facts as represented therein.

> It was held in the recent Supreme Court of Appeal judgment in *Eveready v CSARS* (2012)[80] that the sale agreement had to be interpreted on the facts as they appeared in the sale agreement (para 10, page 5). The Supreme Court of Appeal disallowed oral evidence as to the meaning of the written agreement. The judgment again confirmed the importance of clearly setting out the allocation of the purchase consideration to the various assets during the sale of a sale of business. As previously stated, the transferee may selectively acquire assets of the business as opposed to the total inherent history of the target company when the transaction is structured as a sale of the business concerned. It is, therefore, essential that the transferee identify those assets that are subject to the sale of the business.[81]

With the transfer of a business being common, a critical issue arises as to how the sale of business agreement should be structured in order to determine the appropriate income tax consequences.[82] 'The sale of a business as a going concern can be structured in a variety of ways'.[83] It is common that the sale of

[79] Nates *et al.* 2015: 711
[80] (195/11) [2012] ZASCA 36
[81] Fouche 2013:11
[82] Nates et al. 2015: 707
[83] SARS Interpretation Note 94 2016:2

business agreement is drafted in the sense that the transferee takes on the liabilities of the transferor especially in instances where employees are also transferred across to the transferee.[84] 'A business, generally speaking, does not need to be transferred with any liabilities in order to be able to operate as an income-earning operation in its own right'.[85] The purchase price is generally paid by the transferee through a mixture of a cash payment to the transferor, the undertaking of an obligation to pay specified debts on behalf of the transferor, the transfer of certain contingent liabilities. The type of the liabilities assumed by the transferee could be unconditional or conditional.[86]

'As the tax consequences of a sale agreement will depend on the way the agreement is structured, it is of the utmost importance that a potential transferee and transferor of a business familiarize themselves with the different tax implications that may flow from the sale'.[87] The judgment in the *Ackermans* case relied on the sale agreement between Ackermans Ltd and Pepkor Ltd in delivering the judgment which presupposes that the sale of business agreement is a key determinant with regards to the income tax implications.

Some of the South African literature on the assumption of contingent liabilities during the sale of a business appear to suggest that there are two main possible ways of structuring the sale agreement. The following have been noted by various authors accordingly:

1. The question arises as to whether the decrease in the purchase price or, alternatively, the consideration received by the transferee to induce it to assume the contingent liabilities would result in an amount to be included in the gross income of the transferee.[88] This highlights the two methods of transferring contingent liabilities during the sale of a business. It makes reference to the reduction in purchase consideration which would imply that contingent liabilities would be assumed as the motivation for that

[84] Fouche 2013:7
[85] SARS Interpretation Note 94 2016:2
[86] SARS Interpretation Note 94 2016:2
[87] Olivier 2007:600
[88] Fouche 2013:9

reduction. It also makes reference to the transferor paying the transferee to assume the liability which is the second method of transferring a contingent liability considered in this report.

2. Certain commentators on related topics have expressed the views that the payment or part payment of the purchase consideration by the transferee with the assumption of contingent liabilities is essentially the same from an economic point of view as the transferor making payment to induce the transferee to assume the contingent liabilities.[89] These comments from the SARS Interpretation Note 94 also makes reference to two methods for the assumption of a contingent liability. That is, the part settlement of the purchase price with the assumption of the contingent liabilities and the payment made by the transferor to the transferee for the latter to assume the contingent liability.

3. Any payment made by the transferor in return for being released from the obligation has to be taken into account. If the transferor did not make a specific payment to the transferee for assuming future contingent liabilities, subsequently discharged by the transferee, a recoupment may well arise.[90] This mentions the second method for the transfer of contingent liabilities by making specific reference to payment made by the transferor for being released from the obligation with regards to the contingent liabilities.

4. The agreement is vital in determining the tax implications with regards to the contingent liabilities assumed or transferred. The court held that an unconditional obligation on the part of the transferor had not arisen with respect to the sale agreement on the basis that the transferor has simply accepted a lower purchase consideration. Hence, no expenditure had been incurred by the transferor with regards to the contingent liabilities. Some commentators have indicated that this position could have been different if the agreement had explicitly indicated that the transferor would

[89] SARS Interpretation Note 94 2016:12
[90] Olivier 2007:615

pay the transferee to induce the latter to assume the contingent liability. In that instance the transferor could argue that it has incurred an expenditure.[91] These notes by Nates *et al*. well encapsulate the two methods for the assumption of contingent liabilities.

5. Emslie & Davis noted in the commentary to the *Ackermans* case *supra* that if the business had been sold for a higher price and the transferor simultaneously undertook an unconditional obligation to settle an amount to the transferee for assuming its contingent liabilities, the income tax implication could have been different. This demonstrates how the same commercial substance of the sale of the business agreement can be achieved in a different circumstance in order to arrive at a different income tax consequence.[92] Another example of the different methods with regards to the assumption of contingent liabilities.

The inference on the possible nature of the agreement in terms of the above excerpts of South African literature on related topics seems to suggest two options for the settlement of the purchase consideration. The first option is where the transferee, in addition to the net purchase price paid, assumes certain contingent liabilities of the transferor. The second option is where the transferee pays the transferor in full for the purchase consideration, and the transferor in turn pays the transferee an amount in order for the transferee to assume contingent liabilities of the transferor. These options have been summarised as follows:

1. Method one – Purchase price for the net asset. This is typically gross market value of the assets reduced by the face value of the liabilities (including contingent liabilities). The agreement in such a scenario requires the net asset purchase price (in other words, a reduced purchase price) is paid, and liabilities are assumed, by the transferee for no consideration.

[91] Nates et al. 2015: 712
[92] Emslie & Davis 2012:341

2. Method two – Separate transactions but one agreement. Under this scenario, the gross market value of the assets are sold separately to the transferee. The transferor is however, in terms of the agreement, required to pay the transferee in order for the transferee to assume the liabilities. Eventually the net value (gross market value of assets less face value of liabilities including contingent ones) is settled.

The tax implications for both the transferor and the transferee under each of these methods will be analysed in detail below.

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Chapter 5: Application of the law to assumption of Contingent Liabilities

Under this chapter the principles of income, proceeds and the deductibility of expenditure will be applied to each of the methods for the assumption of contingent liabilities during the sale of a business.

For income, in order for an amount to be included in income, there must be a total amount in cash or otherwise, received by or accrued to or in favour of a taxpayer during a year of assessment excluding receipts or accruals of a capital nature. Where the receipts are of a capital nature, the amount received would have to be considered to be proceeds in terms of the Eighth Schedule.

For expenditure, in order for a variable remuneration expenditure to be deductible, the taxpayer must be carrying on a trade and there should be an expenditure or loss which has been actually incurred, in the production of the income, must not have been of a capital nature and paid by employer to the employee.

The possible methods for the assumption of contingent liabilities during the sale of business as well as the income tax implications thereof have been analysed below. For purposes of this report an example will be used to illustrate the income tax implications and case law principles.

Example

The transferor of a business sold the entire business to the transferee for a total consideration of R60 million. At the time of the sale, the business of the transferor comprised of the following:

Motor vehicles – R100 million
Trade Accruals – R10 million
Leave pay provision – R25 million
Bonus provision – R5 million
Net value of the business – R60 million

The relevant assumptions with respect to this example:

1. The transferor is trading.
2. The Motor Vehicles are allowance assets and will qualify for a wear & tear allowance in terms of section 11(*e*) of the Act.
3. The transferee is required to take over the contracts of the transferor's employees to whom the leave pay provision and bonus provision would relate.
4. The trade accruals are deductible expenditure as they were incurred in the production of the income and are not of a capital nature.
5. In terms of the employment contract, the leave pay provision will be payable to the employees six months post the end of the year of assessment in which the leave pay provision relates. The key condition is that the employees must remain in the employ of the employer at that time. With regards to the bonus, this will be payable to the employees who are still in the employ of the employer six months post the end of the year of assessment in which the bonus provision was raised.

This example has been applied under each of the methods as follows:

Method one *– Purchase price for the net asset. This is typically gross market value of the assets reduced by the face value of the liabilities (including contingent liabilities). The agreement in such a scenario requires that the net asset purchase price is paid (in other words, a reduced purchase price), and liabilities are assumed, by the transferee for no consideration*.

Under method one, the transferee pays R60 million to the transferor and then takes ownership of the motor vehicle and assumes the trade accruals, leave pay provision and bonus provision liabilities.

Implications for the Transferor

Under method one, a business would have been sold to the transferee for R60 million.

> It is worth stating that a business as a whole is not recognised as a single asset for income tax purposes. The business consists of a collection of assets (and possibly liabilities) and the total purchase price must be allocated to the individual assets (and possibly liabilities) which form the subject matter of the sale.[93]

In ITC 108 (1928)[94] the court required an allocation of the purchase price to different assets in the context of the disposal of a going concern.

> It is important to state that in the sale of a business, the first important aspect to keep in mind is that the purchase price should never be expressed as a net (lump) sum, but should be allocated or apportioned between the different assets of the business sold.[95]

In the above simplistic example, the transferor only had one class of asset – motor vehicles - and therefore the purchase price or amount should be allocated to that one class of asset. As the motor vehicles are one class of asset, the term 'motor vehicle' will be used to signify the motor vehicles sold.

Two issues would arise for the transferor. The first issue would be how much the motor vehicle was sold for. The second issue will be whether or not the transferor will get a deduction for the trade accruals, leave pay and bonus provision assumed by the transferee once paid.

Sale of Asset

The first issue at hand is to establish how much the transferor sold the asset for. The definition of disposal includes 'any event which results in the transfer of an asset, and includes the transfer of ownership of an asset'.[96] The business sold by the transferor includes assets of which the ownership has been transferred to the transferee. The sale of the business will, therefore, constitute a disposal event.

93 SARS Interpretation Note 94 2016:5
94 3 SATC 343 (U)
95 Olivier 2007:600
96 Paragraph 1 of the Eighth Schedule

The question then arises as to what will constitute the amount (i.e. purchase price) in the hands of the transferor for the disposal of the motor vehicle. The transferor received R60 million from the transferee and was relieved by the transferee of the trade accruals of R10 million, leave pay provision of R25 million and bonus provision of R5 million.

As indicated above with regards to the *Brummeria Renaissance (Pty) Ltd* case *supra*, it noteworthy to reiterate that for non-cash receipt to be included in gross income, that non-cash receipt should be in a form that a monetary value can be attached to it. The income tax has to be assessed with respect to all receipts or accruals having a monetary value. Where a monetary value cannot be attached to such receipts or accruals, it is disregarded as income.

The transferor essentially received four things for the sale of the asset. The first is the cash of R60 million. The second is the benefit he received from being relieved of the R10 million trade accruals. The third is the benefit he received from being relieved of the R25 million leave pay provision. The fourth is the benefit he received from being relieved of the R5 million bonus provision. These four items have been analysed below in an effort to illustrate which item would constitute gross income in the transferor's hands.

Cash – R60 million

Cash is self-evident that it will constitute an amount as the definition of proceeds makes specific reference to an amount, and an amount has been considered by the courts[97] to include cash. Therefore, the R60 million would be included in the proceeds from the disposal.

Trade Accruals – R10 million

With regards to trade accruals, as this is in a form other than money, it should be assessed whether or not a monetary value can be attached to it. It is key to

[97] The *People's Stores (Walvis bay) (Pty) Ltd* case

establish the nature of trade accruals before proceeding to ascertain its value. Section 19 of the Act and paragraph 12A of the Eighth Schedule contain the definition of debt in the Act. Debt is defined, in terms of these section and paragraph, to mean any amount that is owed by a person. The courts have also offered some clarity on what debt means. In the matter of *Electricity Supply Commission v Stewarts and Lloyds of SA (Pty) Ltd* (1981),[98] it was held that the word 'debt' should be given the meaning ascribed to in the Shorter Oxford English Dictionary. The Shorter Oxford English Dictionary defines the word 'debt' as

> Something owed or due; something (as money, goods, or service) which one person is under an obligation to pay or render to another.

The trade accruals is recognised from an accounting perspective and it's also key to establish its meaning in that regard. IAS 37 defines accruals as an obligation to pay for goods and services that have been delivered or rendered by the supplier, as the case may be, but are yet to be settled.[99] It would follow that trade accruals are liabilities which are yet to be paid and therefore will qualify as debt as defined.

In *People's Stores (Walvis bay) (Pty) Ltd case supra,* Hefer JA held that, the word 'amount', in the context of the gross income definition, must be given a wide interpretation, and must include not only receipt and accrual with a monetary value but the value of other non-cash items accrued to the taxpayer, whether corporeal or incorporeal, which has an ascertainable monetary value. Importantly, the court went on to hold that an amount comprising a debt must be determined with reference to the market value thereof and not its face value.

In addition, in *Mooi v SIR* (1972),[100] Ogilvie-Thompson CJ stated that

> The word 'amount' may be in this context, when a taxpayer becomes entitled to a right 'in respect of services' a money value must be assigned to that right in order to determine the relevant 'amount' to be incorporated as 'gross income'." In essence, when a taxpayer

[98] (3) SA 340 (A)
[99] IASB IAS 37, 2014:11
[100] 1972 (1) SA 675

becomes entitled to a right, a money value must be assigned to that right.

The conclusion reached in all these cases is that the word 'amount' must have a monetary value or must be capable of being valued in money. It is therefore clear that, in the context of the gross income definition, the amount of a debt is the market value thereof and not its face value specifically with reference to the *People's Stores (Walvis bay) (Pty) Ltd* case *supra*. The facts of the *People's Stores (Walvis bay) (Pty) Ltd* case *supra* is fundamental in understanding the conclusion of the court. The taxpayer sold goods under its revolving credit scheme and excluded instalment not yet payable from its gross income. The CIR included instalment not yet payable in the taxable income of the taxpayer. These facts are totally different in these circumstances as the motor vehicles were not sold on credit in the first instance. Therefore, to evaluate the trade accruals on a market value basis seems inappropriate as nothing has been sold on credit having regard to the facts of the *People's Stores (Walvis bay) (Pty) Ltd* case.

The question then also arises as to whether the gross income position with regards to market value applies in the context of the definition of amount for the purposes of determining the value that the transferor had been relieved of in relation to the trade accruals. The transferor was required to pay the suppliers to whom the trade accruals would relate an amount of R10 million. The trade accruals constitute expenditure in the hands of the transferor for which no payment has been made yet.

An important distinction therefore exists in the sense that the gross income definition is concerned with inflows of amounts whereas the definition of 'expenditure' is concerned with outflows of amounts in the form of consideration to be given by the transferor to the respective suppliers. To this end, a comparison to the General Deduction formula in section 11(*a*) of the Act may be apt. While this provision does not refer to an 'amount' it refers to expenditure actually incurred.

In this regard, it was held in the case of *CSARS v Labat Africa Ltd* (2012),[101] with reference to *Caltex Oil* (*SA*) *Ltd v SIR* (1975)[102] that the expression 'any expenditure actually incurred' meant 'all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not'; said differently, the liability or obligation thereof must be discharged by means of an expenditure – the timing is of no relevance.

It has further been held that the word 'incurred' does not merely mean 'paid', but connotes 'the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability'.[103] It is therefore apparent that, in the context of the incurral of expenditure in the form of a debt, it is not the market value of the debt determined with reference to the timing of payment thereof that is taken into account, but the amount of the debt itself.

It is submitted that the same principle should apply in the context of the definition of 'amount' insofar as the amount applied as consideration for the trade accruals forgone is concerned. It is apparent from the *Labat Africa Ltd* case *supra* that any form of expenditure would (at least assuming that a *quid pro quo* is received) constitute consideration which in this instance is the reduction in the purchase price of the asset. Following this reasoning, if the incurral of a debt constitutes expenditure then the incurral of such a debt in exchange for the purchase of an asset, constitutes consideration for the purchase of such asset. If the amount of the expenditure related to the incurral of a debt is the amount of the debt itself (as opposed to the market value of the debt), then the amount of the consideration in relation to the asset sold is also the amount of the debt.

It would follow that the amount of the trade accrual, from which the transferor has been relieved from paying, will constitute an amount (i.e. purchase price) in the hands of the transferor. Therefore, the R10 million will also be included in

101 (2012) 74 SATC 1 (SCA)
102 1975 (1) SA 665 (A)
103 Ackermans case *supra*

the purchase consideration.

Leave Pay Provision – R25 million and Bonus Provision – R5 million

As indicated above, in terms of IAS 37, for leave pay provision, a company shall measure the estimated cost of untaken leave days which may result in a reduction of resources embodying economic gains of that company. As a result, a leave pay provision is merely an accounting estimate. Similarly, for bonus provision, a company shall measure the expected cost of bonus amounts to be paid to employees who have already rendered services to the company when that company has a present obligation to settle such amounts and it can be reliably estimated. It follows that a bonus provision is also merely an accounting estimate.

In line with the trade accruals argument as presented above, as the leave pay and bonus provision relate to expenditure the transferor would have expected to pay had it materialised, it is key to look at these amounts from an expenditure perspective.

In the decision in *Nasionale Pers Bpk* case *supra* the court made it clear that a liability is only actually incurred for income tax purposes when the outcome is certain. It is therefore clear that the leave pay provision and bonus provision will amount to an actual obligation when the uncertainties or probability in relation to their outcomes are eliminated. It is therefore apt to say that as at the date of the sale of the business, the transferor did not have any present obligation with regards to the leave pay provision and bonus provision. The mere fact that there is a liability from an accounting point of view does not in any way indicate that there is a liability from a tax point of view. In this respect, Watermeyer, C.J indicated in *Joffe & Co Ltd* case *supra* that[104]:

> I shall not refer to them in detail but I draw attention to the caution, repeated in them more than once, and also repeated in the case of *Pyott Ltd v CIR (1945,* A.D. *128,* at p. *135),* that **the Court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but**

[104] 1946 AD at 165

> **merely with the deductions which are permissible according to the language of the statute**. (Own emphasis.)

It would hence follow that although from an accounting point of view, there is an obligation, there is no obligation from a tax point of view. It would also follow that from a tax point of view, the transferor was relieved of nothing in terms of the leave pay provision and bonus provision. As the transferor was relieved of nothing, the monetary value of leave pay provision and bonus provision should be nil albeit the R25 million and R5 million estimated amount from an accounting perspective.

Nates *et al*. indicated the following with regards to contingent liabilities in terms of being considered as proceeds:

> **Can one be taxed on something they do not have?**
>
> The view of the paper is that consideration transferred to the transferor comprises of two components the amount transferred and the contingent liability foregone.
>
> The issue with this is that the transferor is taxed on something which does not exist in terms of legislation. If the Act does not recognise a contingent liability because it has not been incurred, how can SARS interpret the legislation to recognise the proceeds?
>
> Will it be possible for the proceeds to have accrued to the transferor as in the case of *Mooi v SIR* (1972 (1) SA 675 (A)), where the judgment made it clear that proceeds would accrue to the taxpayer when they are unconditionally entitled to it? Therefore, as a contingent liability is conditional, should the proceeds not be treated the same way?

In an unreported Case Number 13193 (2017) delivered by Cape Town Tax Court on 22 February 2017, the court had to consider whether the acquisition of contingent rights to dividends is taxable. The court ruled otherwise. In giving the judgment, Van Staden AJ noted that the contingent right is conditional upon the fulfillment of certain conditions and that it was not an ‘amount’ for the purposes of the gross income definition albeit the argument that such right had a monetary value. He stressed the point that those rights were contingents and an unconditional rights will come into existence when all the conditions have been fulfilled.

Similarly, in light of the above, on the date of the sale, the amount of consideration which the transferor has become unconditionally entitled to is R70 million (cash of R60 million and trade accruals of R10 million). The leave pay provision of R25 million and bonus provision of R5 million are contingent liabilities which are merely accounting estimates. It will therefore seem absurd for the transferor to include the accounting estimated amount in relation to the obligation forgone with regards to the leave pay provision and bonus provision in its income having regard to the unreported Case Number 13193 (2017).

Even if one were to put forward an argument that the transferor was relieved of the leave pay provision and bonus provision, and therefore a value must be assigned to these provisions, the question will then arise as to what value should be assigned? As at the date of the sale of the business, the R25 million and R5 million are merely accounting estimates and the transferor did not have any present obligations. Further, from the definition of leave pay provision, it is merely an estimated amount which is likely to change depending on whether or not the affected employees who were also transferred across to the transferee will take the days off. For the bonus provision, this may or may not be paid subject to certain conditions. It can therefore be said that at the date of sale, the benefit (if any) received by the transferor in relation to the leave pay provision and bonus provision could not be ascertained as it is dependent on certain future events and the payments to be made by the transferee with specific reference to such leave days and bonus amounts respectively. This implies that the benefits in relation to the leave pay provision and bonus provision forgone by the transferor could not be quantified at the date of the sale of the business.

In 2004, a specific section was introduced in the Act to deal with the incurrence and accrual of unquantified amounts.[105]

Section 24M states that:

> If a person during any year of assessment disposes of an asset for consideration which consists or includes an amount which cannot be quantified in that year of assessment, so

[105] Olivier 2007:711

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> much of that consideration as—(*a*) cannot be quantified in that year must for purposes of this Act be deemed not have accrued to that person in that year; and
> (*b*) becomes quantifiable during any subsequent year of assessment must for the purposes of this Act be deemed to have been accrued to that person from that disposal in that subsequent year.

The words 'cannot be quantified' are not defined in section 24M of the Act. The CGT Guide indicates the following:

> Of course virtually anything can be quantified by attaching a number to it through estimation. Such a wide interpretation would defeat the object of section 24M of the Act. It is submitted that section 24M of the Act is directed at preventing the estimation of amounts when the quantum of the amount is dependent on future events. This interpretation is consistent with the meaning of the word 'amount' in the *Butcher Bros* case *supra*, and the way in which the word 'quantified' was used *in CIR v Edgars Stores Ltd*[106] and ITC 1601. Section 24M therefore essentially entrenches the common law position.[107]

The Explanatory Memorandum attendant to the introduction of section 24M stated the following:

> If a person disposes of a capital asset for consideration that cannot be quantified in whole or in part, that transferor will be viewed as accruing only the portion of the consideration that can be quantified during the year of disposal (proposed section 24M(1)). Unquantified consideration only accrues in later years as those amounts become quantifiable (i.e., are fixed). The transferor no longer needs to predict future events to determine current capital gains/losses on disposal.
> In mechanical terms, the transferor determines capital gains/losses during the initial year of disposal under normal capital gain rules, except that the proceeds for the initial year are taken into account only to the extent those amounts can be fully quantified. This calculation triggers an initial capital gain or loss. Initial capital gains generate tax just like any other capital gain. Initial capital losses are however disregarded (i.e., suspended) during that year (paragraph 39A(1) of the Eighth Schedule). The transferor must then account for further consideration in later years as that consideration becomes quantified (fully due and payable).

Therefore, in such circumstances the transferor will be taxed only when the profits accrue each year and the transferee can only claim a deduction if and when the profits are paid over.[108] The section 24M of the Act rule applies for the

[106] (4) SA (T), 48 SATC 89
[107] SARS CGT Guide 2015:386
[108] Olivier 2007:711

purposes of the Act, which includes the Eighth Schedule. It therefore covers both capital assets and trading stock.[109]

It follows that for assets treated on revenue account, the amount will constitute gross income when the taxpayer becomes unconditionally entitled to it.[110] For assets treated on capital account, a specific provision is catered for under paragraph 3*(b)* of the Eighth Schedule. It states the following:

> **3. Capital gain.—**A person's capital gain for a year of assessment, in respect of the disposal of an asset**—**
> **…**
> (*b*) in a previous year of assessment, other than a disposal contemplated in subparagraph (*c*) is equal to**—**
> (*i*) so much of any amount received by or accrued to that person during the current year of assessment, as constitutes part of the proceeds of that disposal which has not been taken into account**—**
> *(aa)* during any year in determining the capital gain or capital loss in respect of that disposal; or
> *(bb)* in redetermination of the capital gain or capital loss in terms of paragraph 25(2);…

It follows from both the capital and revenue perspective, the amount of leave pay provision and bonus provision which were not quantifiable as at the date of sale will only be considered for tax purposes when such amounts become quantifiable. As indicated above the leave pay provision and bonus provision will only be payable to the employee depending on certain conditions.

In light of the above, the gross income or proceeds from the sale will equate to the R70 million plus the quantifiable amount of the leave pay provision and bonus provision. The question then arises as to when these amounts will become quantifiable. It is submitted that the best approach is for the transferor to constantly liaise with the transferee in order to ascertain when the leave pay provision and bonus provision are settled and the respective amounts incurred by the transferee. At this stage, the leave pay provision and bonus provision forgone by the transferor will become quantifiable.

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109 SARS CGT Guide 2015:421
110 Emslie & Davis 2012:63

Deductibility of the Contingent Liability

The second issue is to determine whether or not the transferor would qualify for a deduction in terms of the leave pay provision and bonus provision forgone. As outlined above, in order for the transferor to qualify for a deduction, the first step will be to determine if the transferor has incurred an expenditure in respect of the leave pay provision and bonus provision.

The above example is similar to the facts of the *Ackermans* case and therefore a comparison to the arguments held in that case may be apt. The following were held in the Ackermans case:[111]

> That 'expenditure incurred' meant the undertaking of an obligation to pay or (which amounted to the same thing) the actual incurring of a liability but no liability had been incurred by appellant to the transferee in terms of the sale agreement and the manner in which the purchase price had been discharged by the transferee did not result in the discharge of any obligation owed by appellant to the transferee. That the fact that appellant had rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, did not mean in fact or in law that it had incurred expenditure to the extent that the purchase price had been reduced by the liabilities and at the effective date no expenditure had actually been incurred by appellant and, accordingly, appellants had failed at the first hurdle and were not entitled to claim a deduction in terms of s 11(*a*) of the Act in respect of the three contingent liabilities in issue in the 2004 year of assessment.

It can therefore be concluded that the transferor will not incur an expenditure with regards to the liability forgone as the transferor did not undertake an obligation to pay the leave pay provision and bonus provision in terms of the agreement.

Implications for the Transferee

With regards to the transferee, two issues would arise. The first issue is ascertaining a value to the motor vehicle acquired. The second issue is determining whether the transferee will qualify for a deduction when the leave

[111] 73 SATC 1 at 2 and 3

pay provision and bonus provision are paid out to the employees. These have been discussed below as follows:

Value of Asset Acquired (Base Cost of Asset Acquired)

Base Cost of an asset is dealt with in Part V (paragraphs 20 to 34) of the Eighth Schedule. Base Cost is defined as, amongst others, the expenditure actually incurred in respect of the cost of acquisition or creation of that asset. This would generally equate to the acquisition costs and other direct costs that can be ascribed to such acquisition.

As outlined above the expression 'any expenditure actually incurred' meant all expenditure for which an unconditional obligation has arose during that year of assessment whether or not such unconditional obligation has been discharged during that year of assessment.[112]

The transferee, in addition to the payment of R60 million cash for the motor vehicle assumed the following liabilities:

1. Trade Accruals – R10 million
2. Leave pay provision – R25 million
3. Bonus provision – R5 million

For the trade accruals, these are actual liabilities that the transferee would be required to settle. There are no conditions attached to such settlement. Hence, the undertaking by the transferee to pay the trade accruals would imply that an obligation to pay has been established on the date of the transfer.

For the leave pay provision and bonus provision, although the transferee has undertaken an obligation to settle them in future, they are contingent liabilities which would only become actual liabilities when the conditions attendant are eliminated. It is therefore clear that a contingent liability will only actually have

[112] *Supra*

been incurred when uncertainties or the probability in relation to its outcome is eliminated. It would follow that if a transferee of a business had assumed contingent liabilities in its books at the time of the purchase of the business, no incurral of expenditure would have occurred.

Accordingly, the base cost of the asset purchased on the date of transfer will be R70 million comprising of cash of R60 million and trade accruals of R10 million.

Deductibility of the leave pay provision and bonus provision when incurred

In the *Ackermans* case *supra*, the court indicated as *obiter dictum* that there will be no bar to the transferee (Pepkor Ltd) deducting the contingent liabilities as and when they became unconditional. The question then arises as to whether the transferee will be entitled to a deduction when the leave pay provision and bonus provision become unconditional.

The following argument put forward by Olivier (2007:616) is noted in this regard. If the transferee (as is typically the case) takes over the employment contracts of the employees pursuant to the acquisition of the business and pays the leave pay and bonus in line with the contracts of employment, the transferee will incur expenditure in the production of income. The Tax Court is of the view that the transferee should be entitled to a section 11(*a*) deduction in instances where no economic loss was suffered. In another unreported Case Number 11107 (2005) delivered by Pretoria Tax Court, the court refused to accept the SARS view that subsequent payment of the leave and bonus payments was of a capital nature. A different conclusion was however reached by the Privy Council in New Zealand in *Commissioner of Inland Revenue v New Zealand Forest Research Institute Ltd* (2000).[113]

> It was held that expenditure incurred on the acquisition of the provisions/liabilities represents capital expenditure in the hands of the transferee. The reason is that expenditure paid for the acquisition of assets is capital expenditure. In other words, the expenditure is more closely related to the income producing concern than to the income

[113] STC 522

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producing activities. The result is that subsequent discharge by the purchase of the obligation represents expenditure of a capital nature notwithstanding the fact that the original payment would have been of a revenue nature.

The above note by Olivier essentially outlay two outcomes. It's either the transferee will get a section 11(*a*) of the Act deduction or the expenditure will be treated as a capital expenditure in which case a section 11(*e*) could be obtained. It is important to understand how the transferee arrived with that obligation to pay the leave and bonus in the first instance. The transferee assumed the leave pay provision and bonus provision as part of an acquisition of an asset. An argument could therefore be put forward that the leave pay provision and bonus provision are closely linked to the acquisition of the asset and therefore should take the form (capital or revenue nature) of the underlying asset. As discussed above, the four tests as indicated by Davis *et al*. in determining the capital or revenue nature of an expenditure are categorized as follows:

1. enduring benefit;
2. once and for all;
3. closeness of connection between the expenditure and the income producing activities; and
4. fixed or floating capital.

Consideration of the leave pay provision and bonus provision against the four tests could result in either a capital expenditure or revenue expenditure. This is because if the leave pay provision and bonus provision are to be measured in isolation, without the underlying asset, against these four tests, the expenditure thereof would be revenue in nature as indicated below:

1. Payment of the leave pay provision and bonus provision would not lead to an enduring benefit;
2. The leave pay provision and bonus provision are not 'once and for all expenditure' as this may be continued to be incurred for the employees in future;

3. The leave pay provision and bonus provision will be closely linked to the income producing activities as they relate to employees;
4. The leave pay provision and bonus provision will be floating capital as they relate to payment to employees.

The vice versa of the above immediate numbered points will arise if one were to link the incurral of the leave pay provision and bonus provision to the acquisition of assets.

Regardless of which income tax consideration is correct, the transferee will get a deduction of the leave pay provision and bonus provision. This is because, where the leave pay provision and bonus provision are treated as revenue in nature upon incurral, the transferee will get a deduction in the year of assessment that incurral occurs in terms of section 11(*a*) of the Act. On the other hand, where the leave pay provision and bonus provision are treated as capital in nature post incurral the transferee may get a deduction by way of wear and tear allowance in terms of section 11(*e*) of the Act. The section 11(*e*) is discussed below:

What has occurred in terms of the above example is simply the purchase of an asset, the consideration was selected by, amongst others, the assumption of contingent liabilities (leave pay provision and bonus provision). As the leave pay provision and bonus provision are conditional in nature, the transferee would not have undertaken any obligation to incur an expenditure in that regard. In future however, when the conditions attendant to the leave pay provision and bonus provision are eliminated and an obligation to incur expenditure in that regard arises the transferee would have incurred an expenditure. In this regard, section 24M may provide guidance as follows.

Section 24M(2) states that:

> If a person during any year of assessment acquires an asset for consideration which consists of or includes an amount which cannot be quantified in that year of assessment, so much of that consideration as–

> (*a*) cannot be quantified in that year must for purposes of this Act be deemed not to have been incurred by that person in that year; and
> (*b*) becomes quantifiable during any subsequent year of assessment must for purposes of this Act be deemed to have been incurred by that person in respect of the acquisition of that asset in that subsequent year.

It would therefore make sense that on the date of transfer, the base cost of the motor vehicle in the hands of the transferee should be R70 million (cash of R60 million plus trade accrual of R10 million). On that same date, the liability to be settled in terms of the leave pay provision and bonus provision could not be ascertained. That said, when the leave pay provision and bonus provision become unconditional the values incurred can be quantified and therefore the base cost of the motor vehicle should then be increased to the R70 million plus the value incurred thereof in line with section 24M of the Act. As the motor vehicle is an allowance asset and qualifies for a section 11(*e*) of the Act allowance, the transferee will get a deduction over the appropriate period.

Conclusion on Method One

The transferor should recognise proceeds of R70 million (cash of R60 million plus trade accrual forgone of R10 million) for the sale of the motor vehicle as there are the amounts received. When an expenditure (say R30 million) in respect of the leave pay provision and bonus provision are incurred by the transferee, the transferor should then recognise the additional proceeds of R30 million in terms of section 24M of the Act.

The transferee should recognise a base cost of R70 million for the asset purchased. When an expenditure (say R30 million) in respect of the leave pay provision and bonus provision is incurred, the transferee should recognise additional base cost of R30 million in terms of section 24M of the Act. Where the transferee could ascertain that the R30 million is revenue, as opposed to capital, in nature a section 11(*a*) of the Act deduction could instead be obtained.

Method Two– *separate transactions but one agreement. Under this scenario, the gross market value of the assets are sold separately to the transferee. The*

transferor is however, in terms of the agreement, required to pay the transferee in order for the transferee to assume the liabilities. Eventually the nets value (gross market value of assets less face value of liabilities including contingent ones) is settled.

Applying the same example to Method Two, it would mean that the transferee paid R100 million cash to the transferor for the purchase of the motor vehicle. The transferor then paid the transferee R30 million cash in order for the latter to assume the trade accrual (R10 million), leave pay provision (R25 million) and bonus provision (R5 million). The tax implications under Method Two have been analysed below:

Implications for the Transferor

Where the sale of business agreement is structured as is in Method Two, two considerations are key for the transferor. The first is what should be considered as proceeds from the sale of asset; the second will be whether or not the transferor incurred an expenditure by paying the transferee to assume the trade accrual (R10), leave pay provision (R25) and bonus provision (R5) and if yes, is that expenditure deductible.

Proceeds

The proceeds from the disposal of the motor vehicle under Method Two is clearly specified in the sale of business agreement and this has been given as R100 million.

Deductibility of trade accrual, leave pay provision and bonus provision paid

Trade Accrual (R10 million)

Reference is made to the *Labat Africa Ltd* case *supra* and the *Port Elizabeth Electric Tramway Co* case *supra* wherein it was stated that expenditure actually incurred does not necessarily correlate to an expenditure actually paid. As long

as the taxpayer can demonstrate that there exists an unconditional obligation to pay such expenditure, it has been incurred and thus deductible. It is in the year of assessment in which the unconditional obligation arose that the expenditure is deductible and not the year of assessment that such an expenditure is paid (i.e. if paid in subsequent year).[114] This would imply that the transferor would have qualified for a deduction with respect to the trade accruals when the unconditional obligation to pay the trade accruals arose. Therefore, the payment of the trade accrual to the transferee will not result in another deduction for the transferor.

Leave Pay Provision (R25 million) and Bonus Provision (R5 million)

With regards to the leave pay provision and bonus provision, no section 11(*a*) of the Act deduction would have been taken by the transferor at the date of the sale of the business. The key question is whether the transferor has incurred an expenditure by paying the transferee to assume the liabilities and whether that expenditure qualify for a deduction under section 11(*a*) of the Act.

> If the transferor paid the transferee a specific amount for assuming bonus and leave obligations, he will only be entitled to a deduction under section 11(*a*), to the extent that he can prove that the expenditure was incurred in the production of income.[115]

The meaning of expenditure was considered in the *Joffe & Co (Pty) Ltd* case *supra* where Watermeyer CJ stated that expenditure usually means a voluntary payment of money. It would therefore follow that there is an 'expenditure' when the transferor paid the transferee for the latter to assume the leave pay provision and bonus provision. This is further supported by a decision in an unreported case handed down in the Johannesburg Tax Court on 14 May 2009. This unreported case raised certain issues which are vital with respect to the deductibility of contingent liabilities assumed as part of a sale of business. The case was reported in a 'Synopsis: Tax Today' article issued by PwC South

[114] Williams 2015:428
[115] Olivier 2007:615

Africa in May 2009. It is worth stating that the article was written by RC (Bob) Williams. The salient points from this case as noted are as follows:[116]

> The court said that the claimed deductions would constitute "expenditure", within the meaning of section 11(*a*), only if one accepted the transferor's construction of the agreement as being that the transferor had "paid" the transferee an amount equivalent to the contingent liabilities in order to be relieved of the transferor's liabilities.
>
> Said by the court, however that even if this interpretation of the agreement were accepted (despite being in conflict with the transferor's accounting records) it did not overcome the difficulty faced by the transferor. The difficulty was that the liabilities in question had not yet become unconditional on the date when the business was sold and the liabilities were transferred to the transferee. Until the liabilities were not contingent, they did not constitute expenditure that had been "incurred", as interpreted in the 1986 Appellate Division decision in *Nasionale Pers Bpk v KBI*.

The court went on further to indicate that to that extent that such contingent liability qualified as expenditure, it would not be expenditure incurred in the production of income in terms of section 11(*a*) of the Act as it was not an expenditure before the business was sold.[117] Furthermore, indicated by the court, that the to the extent that an argument is put forward that it qualified as an expenditure it would be an expenditure incurred to motivate the transferee to assume the liabilities as opposed to in the production of income.[118] In addition, the court indicated that even if all the difficulties that disqualified the payment as deductible were to be overcame, there was no way the transferor can disprove that the expenditure was not incurred for the purposes of the cessation of a business – that way the 'in the production of income' test will not be met.[119]

Lastly, the court indicated that the expenditure has been laid out not for the purposes of the transferor's trade and thus that expenditure will fall foul of section 23(*g*) of the Act as the transferor was bringing its trade to a close.[120]

The above points, in *obiter dictum*, made by the court indicate that although the transferor had incurred an expenditure by paying the transferee in terms of the sale of business agreement to assume the leave pay provision and bonus provision the transferee would not be able to deduct the expenditure in terms of section 11(*a*) of the Act on the basis, amongst others, that the expenditure was not in the production of the income. This is because the expenditure was linked

[116] PwC South Africa Tax Today 2009:6
[117] *Supra*
[118] *Supra*
[119] *Supra*
[120] *Supra*

to income earned by the transferor before the sale of the business, and not to income that would result from the sale. Therefore, the transferor will not qualify for a deduction with regards to the leave pay provision and bonus provision in terms of section 11(*a*) of the Act.

Implications for the Transferee

With regards to the transferee in terms of Method Two, the three key considerations are as follows:

1. The base cost of the motor vehicle acquired.
2. Whether the transferee should be taxed on the consideration received from the transferor for the assumption of the trade accruals, leave pay provision and bonus provision?
3. Whether the transferee will qualify for a deduction when the liabilities with regards to the trade accruals, leave pay provision and bonus provision are paid?

Base Cost of Asset Acquired

Base Cost of an asset, per paragraph 20 of the Eighth Schedule, is the expenditure actually incurred in respect of the acquisition of an asset. This would generally equate to the acquisition costs and other direct costs that can be ascribed to such acquisition. Therefore as the transferee paid R100 million for the acquisition of the motor vehicle, the base cost thereof will be R100 million.

Consideration Received for the Assumption of Trade Accrual (R10 million), Leave Pay Provision (R25 million) and Bonus Provision (R5 million)

'It noted that if the transferee receives an amount as payment for assuming actual liabilities, it may be argued that he will be taxed on the receipt'.[121] As

[121] Olivier 2007:616

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outlined above, there are three key constituents of the gross income definition which are vital to the requirements of 'gross income' as follows:

- total amount in cash or otherwise;
- received by or accrued to in favour of; and
- excluding receipts of a capital nature.

These requirements have been considered below.

Total amount in cash or otherwise

There is no doubt that as the transferee received an amount of R40 million (Trade Accrual - R10 million, Leave Pay Provision - R25 million and Bonus Provision - R5 million), an amount has been received in terms of the gross income definition.

Received by or accrued to in favour of

As analysed above, it is settled law that the words 'accrued to' mean that a person has become unconditionally entitled to an amount.[122] Generally, where an amount is not received for one's own benefit, such a receipt is excluded from a taxpayer's gross income. The question then arises as to whether the transferee has become unconditionally entitled to the consideration received and whether such consideration is for its own benefit. The answer to these questions are yes because of the following:

1. The transferor does not have any recourse to the amount paid to the transferee.
2. Should the employees not meet the qualifying conditions for the leave pay provision and bonus provision to be paid to them, the consideration received by the transferee will be for its own benefit. The amount will not be paid back to the transferor.

[122] *Supra*

It can therefore be concluded that the transferee, upon receipt of the consideration for the assumption of the trade accrual, leave pay provision and bonus provision, received such consideration for its benefits and became unconditionally entitled to such receipt.

Excluding receipts of a capital nature

It is well established that where an amount received relates to a taxpayer's income earning operations it will be revenue in nature, but if the amount received relates to the income earning structure it will be capital in nature. The purpose of the receipt of the consideration is to pay the trade creditors and the employees when the conditions with respect to the leave pay provision and bonus provision are met. The receipt does not in any way affect the income earning structure of the transferee.

Secondly in the case of *WJ Fourie Beleggings CC v CSARS* (2008)[123] where the court had to decide whether compensation payment for cancellation of trading contract will be capital or revenue in nature in the hands of the recipient, the court had relied on amongst others the following:[124]

> …when the benefit surrendered on calculation does not represent the loss of an enduring asset in circumstances such as those above mentioned – where for example the structure of the recipient's business is so fashioned as to absorb the shock as one of the normal incidents to be looked for and where it appears that the compensation received is no more than a *surrogatum* for the future profits surrendered – the compensation received is in use to be treated as a revenue receipt and not a capital receipt.
> …
> If it is shown that the cancellation of a commercial contract affected the profit-making structure of the business or that it affected the whole manner in which the business is conducted and that compensation has been paid therefore then that compensation would be of a capital nature…

In the example with reference to Method Two, the transferee is essentially receiving a compensation for the subsequent settlement of the trade accruals, leave pay provision and bonus provision. The compensation received by the

[123] 70 SATC 8
[124] 70 SATC 8 at17

transferee will not in any way affect the whole manner in which the business of the transferee is conducted. The receipt in the hands of the transferee will therefore be revenue in nature.

Therefore the R40 million received by the transferee will be included in the gross income of the transferee. This will represent income received in advance and therefore it is key to explore whether the transferee can qualify for a section 24C of the Act allowance especially as the transferee is required to make payment of the receipt. 'On the assumption that the amount is indeed taxable a deduction under section 24C may be claimed.'[125]

Section 24C of the Act deals with allowance in respect of future expenditure on contracts. In terms of section 24C(2) of the Act,

> 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 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 the taxpayer's obligation 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) in respect of so much of such future expenditure as relates to the said amount.

Section 24C(2) of the Act highlights certain requirements that should be met before a section 24C allowance can be claimed. Notable among such requirements is that the contract in terms of which an amount was received and the contract in terms of which the taxpayer performs the obligation must be the same. In the example, the consideration was received by the transferee with respect to the sale of business agreement. The obligation to pay the trade creditors arose from the contract between the transferor and the trade creditors. The obligation to pay the employees for the leave pay provision and bonus provision arose from the employment contract between the transferor and the affected employees. All these are different contracts and therefore one of the requirements of a section 24C allowance will not be met. Hence, the transferee will not be entitled to a section 24C allowance.

[125] Olivier 2007:616

Deductibility of Trade Accruals (R10 million), Leave Pay Provision (R25 million) and Bonus Provision (R5 million)

As the transferee has been taxed on the receipt, the expenditure from the subsequent payment of the trade accruals, leave pay provision and bonus provision will be incurred in the production of income. The transferee will therefore be entitled to a deduction under section 11(*a*) of the Act.

> It is stated that if the transferee receives an amount as payment for assuming actual liabilities, it may be argued that he will be taxed on the receipt. ... A deduction may also be claimed under section 11(*a*) when the leave and bonus payments are actually incurred. The end result is that the transferee will be taxed on that part of the amount not used to pay bonuses or leave.[126]

Conclusion on Method Two

The transferor should recognise proceeds of R100 million for the sale of the motor vehicle as this is the amount received. The payment of the trade accrual (R10 million), leave pay provision (R25 million) and bonus provision (R5 million) will not amount to a deductible expenditure in terms of section 11(*a*) of the Act.

The transferee should recognise a base cost of R100 million for the asset purchased. The payment of R40 million received by the transferee for the assumption of the trade accruals, leave pay provision and bonus provision will constitute gross income. The transferee will not be entitled to a section 24C allowance. When the transferee incurs an expenditure upon subsequent payment of the trade accruals, leave pay provision and bonus provision, the transferee will be entitled to a deduction in terms of section 11(*a*) of the Act. This is on basis that the transferee has already been taxed on the R40 million when it received it from the transferor in respect of the trade accrual, leave pay provision and bonus provision.

[126] Olivier 2007:616

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Chapter 6: The SARS's View

The SARS released Interpretation Note 94, on 19 December 2016, which provides guidance on the income tax implication of the assumption of contingent liabilities (such as leave pay provisions and bonus provisions). Interpretation Note 94 depicts the income tax consequences imputable to the transferor including the transferee where the cost of acquisition of an asset, as a going concern is concluded or partly concluded by acquiesces of a contingent liability. The purpose of this chapter is to analyse the conclusion reached in the Interpretation Note 94.

An understanding of the legal status of Interpretation Notes issued by the SARS is important for the purposes of this chapter. Stiglingh *et al.* notes the following with respect to Interpretation Notes:[127]

> In addition to the regulations, SARS publishes Interpretation Notes (previously Practice Notes) that set out its interpretation of various provisions of the Act. These Interpretation Notes do not form part of tax legislation…. **These Interpretation Notes are simply SARS's interpretation regarding the relevant provisions and do not have the force of law**. They serve only as guidelines. If challenged in courts of law, they may be overthrown. A taxpayer may therefore challenge the practice of SARS as set out in a particular Interpretation Note. **It appears that not even the Commissioner is bound by an Interpretation Note unless it contains a statement that it is a Binding General Ruling in which instance the Commissioner is bound to its interpretation**. (Own emphasis.)

Interpretation Note 94 does not contain a statement that it is a Binding General Ruling. Therefore, the Commissioner is not bound by the conclusion reached in Interpretation Note 94.

Notwithstanding the above, Tax Consulting South Africa issued an online article on 6 October 2016 regarding the SARS' Interpretation Notes following a recent case at the Supreme Court of Appeal that had relied extensively on an Interpretation Note.

The following is noted from the article. The case bordered on whether or not the actual supply does not qualify for the zero rating and that only unrequited or gratuitous payments could qualify. The court relied, amongst others,

[127] Stiglingh *et al.* 2017:18

Interpretation Note 39 which explained the basis behind section 8(5) and section 11(2)(*n*) of the Vat Act.

Dambuza JA, in delivering the unanimous decision of the Supreme Court of Appeal (at 33), quoted extensively from the Interpretation Note. Dambuza JA made the following statement with regards to Interpretation Note:

> These Interpretation Notes, though not binding on the courts or a taxpayer, constitute persuasive explanations in relation to the interpretation and application of the statutory provision in question. Interpretation Note 39 has been in circulation for years and has not been brought into contention until now.
>
> The exact legal basis for this is, however, not clear from the judgment, despite the footnote reference to "AP de Koker and RC Williams Silke on South African Income Tax [Service Issue 57, 2016] at § 18.270". It may be argued that this statement by the Supreme Court of Appeal does to some extent elevate a SARS opinion on the correct application of the law in the form of an Interpretation Note above that of, for example a taxpayer.

No guidance was given by the judge on what 'persuasive explanations' mean. As indicated above, SARS is not bound to their own Interpretation Notes.

Whilst the courts have placed reliance on SARS's Interpretation Notes, it does not give any indication that the conclusion reached in such Interpretation Notes are binding on the SARS. In fact, the judgment given by Dambuza JA has recently been challenged in *Marshall NO and others v Commissioner for the South African Revenue Service* (2018)[128] held at the Constitutional Court of South Africa on 25 April 2018. In giving the judgment, Froneman J observed the following:

> Missing from this reformulation is any explicit mention of a further fundamental contextual change, that from legislative supremacy to constitutional democracy. Why should a unilateral practice of one part of the executive arm of government play a role in the determination of the reasonable meaning to be given to a statutory provision? It might conceivably be justified where the practice is evidence of an impartial application of a custom recognised by all concerned, but not where the practice is unilaterally established by one of the litigating parties. In those circumstances it is difficult to see what advantage evidence of the unilateral practice will have for the objective and independent interpretation by the courts of the meaning of legislation, in accordance with constitutionally compliant precepts. It is best avoided.[129]

PwC South Africa recently wrote an article on the *Marshall NO and others* case in May 2018. The following salient points from that article are noted below:

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[128] JOL 39828 (CC)
[129] JOL 39828 (CC) at 10

> Stripped down to this examination, interpretation notes are revealed as lacking independence, being the view of one of the litigants in any tax dispute. Essentially, a court should consider the interpretation of the words used in a statute objectively and independently. This judgment places interpretation notes firmly in perspective. Neither SARS nor a taxpayer should base a case of interpretation on the content of an interpretation note. It is the duty of the court to determine the interpretation objectively and independently. Furthermore, they lack true contextual relevance, as they are issued well after the preparation and promulgation of the legislation to which they relate.

The judgment by the Constitutional Court in the *Marshall NO and others* has provided guidance to taxpayers with regards to reliance placed on Interpretation Notes by both SARS and taxpayers.

With regards to Interpretation Note 94 which as stated outlines the income tax consequences imputed to the transferor including the transferee in relation to the assumption of contingent liabilities.

The analysis to follow in the remainder of this chapter will be categorized as follows:

1. The conclusion reached by the SARS with regards either the transferor or the transferee in relation to the assumption of contingent liabilities will be stated.

2. The basis of this conclusion will then be given.

3. Thereafter, an analysis of the above numbered items will be given in order to ascertain whether or not there are in disagreements in that regard.

The Transferor

Proceeds from the disposal

The SARS's View:[130] The transferor must, depending on the nature (i.e. revenue or capital) of the underlying asset increase the proceeds or gross

[130] SARS Interpretation Note 94 2016:22

income, as the case may, obtained from the disposal of that asset by the value attributable to the separately identifiable contingent liability forgone.

Basis of the SARS's View:[131] Where the consideration for the acquisition of an asset as part of a going concern comprises of part cash and part assumption of the separately identifiable contingent liability, the transferor receives two things from the transferee as follows:

1. Cash; and

2. The second being the relief from the burden of settling the separately identifiable contingent liability in the event that it becomes unconditionally incurred in the future.

Therefore the benefits received in the form of cash and the contingent liabilities forgone must be included in gross income. The quantification of cash is easy to determine as it will be the actual amount received. The quantification, however, for the received benefit in relation to contingent liability forgone in the hands of the transferor could be challenging. Determining the quantitative value of the benefits must be done by way of objective procedures underpinning the arm's length principle highlighted in section 31 of the Act.[132] In line with the aforementioned principle, the particulars of the case and the intentions of the parties would have to be taken into consideration in determining the value of the contingent liabilities includable in proceeds or gross income.

The SARS indicated further that the facts of the *Brummeria* case is vital to gaining an understanding of how the value should be calculated. The starting point is to identify whether or not the receipt or accrual in a non-cash form has a quantifiable monetary value. The SARS contends that the amount of the separately identifiable contingent liability should be the value which has been agreed between the two parties and stated in the sale of business

[131] SARS Interpretation Note 94 2016:7

[132] In the *Brummeria* case the court found that *Stander v CIR* 1997 (3) SA 617 (C), 59 SATC 21 incorrectly reflected the law when it held that the determination of monetary value was a subjective test.

agreement.[133] This value in terms of Interpretation Note 94 is the face value of the amount which has been agreed between the parties without an adjustment of any present value calculation albeit the fact that the payment will only be made in future.[134]

Comments: It is quite interesting how the SARS requires the transferor to include a value of the contingent liabilities in the gross income or proceeds as appropriate. As already established above, a contingent liability is purely an accounting estimate and is not recognised for tax purposes.

There is no doubt that the transferor received two things from the transferee in relation to the sale of the assets. The only concern is that as at the date of sale, both the transferor and the transferee cannot determine if the contingent liability will become unconditional and if it does which amount will be expended to settle it. It would follow that as at the date of the sale of the business, the value of the contingent liabilities were not ascertainable. This is on the basis that the amount to be paid were subject to certain qualifying conditions (for example, the employees remaining in the employ of the transferee at a certain date). Therefore, to require the transferor to include the face value of the contingent liability in gross income or proceeds, as the case may be, seems quite absurd. If the transferor includes say a contingent liability assumed by the transferee of R12 million in its gross income but only R8 million of these contingent liability become unconditional in future and settled by the transferee, the Act does not seem to offer the transferor any recourse to the additional R4 million already taxed on.

It is also very interesting how the SARS did not consider section 24M of the Act. The transferor received two things – cash and relief from settling the contingent

[133] The agreement must be read as a whole and particular attention be given to the wording used in the applicable annexures – see *Eveready (Pty) Ltd v CSARS* (2012) JOL 28648 (SCA), 74 SATC 185.

[134] The proviso to the definition of "gross income" in section 1(1) and paragraph 35(4) of the Eighth Schedule provide clarity in this regard. It is noted that in reaching the agreed amount, which may differ from the face value of the contingent liability previously recorded in the transferor's accounting records, the transferor and transferee may have included an element of present value adjustment. The agreed amount is, however, not required to be adjusted for any present value elements as the case may be.

liability – from the transferee. The cash is self-evident that it is known at the date of the sale of the business. The 'relief from settling the contingent liability' can only be determined in future when it becomes known. Therefore at the date of sale of the business, the 'relief from settling the contingent liability' remained unknown. Section 24M of the Act could therefore be relied upon by SARS in analysing how the 'relief from settling the contingent liability' should be treated for tax purposes.

There is no doubt that the transferor should include the 'relief from settling the contingent liability' as outlined by the SARS. The only disagreement with Interpretation Note 94 is the timing and value of such inclusion in the transferor's gross income or proceeds as the case may be.

Incurral of expenditure

The SARS's View:[135] The transferor does not in relation to the assumption of the separately identifiable contingent liabilities incur an expenditure and hence, it is not entitled to a deduction with respect to 11(*a*) of the Act.

Basis of the SARS's View:[136] Where the transferee assumes a separately identifiable contingent liability to motivate a reduction in the purchase consideration of the asset, the transferor will not be deemed to have incurred an expenditure with regards to the contingent liabilities forgone. Applying these principles[137], it is ostensible that with regards to the cases on expenditure, a taxpayer must consciously outlay or expend cash or must have an unconditional obligation to expend cash in future in order to qualify as expenditure as considered.

Comments: The analysis performed in this report is consistent with SARS's view regarding the deductibility of contingent liability where the purchase

[135] SARS Interpretation Note 94 2016:22
[136] SARS Interpretation Note 94 2016:9
[137] The SARS relied on mostly case laws in reaching this conclusion. Some of the cases relied upon by SARS includes *Joffe & Co (Pty) Ltd v CIR* 1946 AD 157, 13 SATC 354 at 360*, English case of Allen (HM Inspector of Taxes) v Farquharson Brothers and Co* 17 TC 59 at 64, *COT v Rendle Beadle* 1965 (1) SA 59 (SRAD), 26 SATC 326 at 329*, C: SARS v Labat Africa Ltd* 2013 (2) SA 33 (SCA), 74 SATC 1 and *the Ackermans case.*

consideration of assets bought as part of sale of business is paid or partly paid by the transferee assuming certain contingent liabilities.

The Transferee

Incurral of an expenditure and deductibility

The SARS's View:[138] The transferee will be deemed to have incurred an expenditure provided the conditions attached to the separately identifiable contingent liabilities are fulfilled and the transferee is required to undertake an unconditional obligation to make payments. The deductibility of that expenditure in relation to the separately identifiable contingent liabilities must be specifically determined by the deduction and allowance sections and paragraphs of the Act on the asset to which such contingent liabilities motivated the reduction in the purchase price.

Basis of the SARS's View:[139] The type of consideration may outline if the transferee has incurred an expenditure for income tax purposes on the date of the sale and that will guide the type of deductions and allowances the transferee will qualify for. By way of an example, take it that the transferee is required to pay cash and assume trade creditors and separately identifiable contingent liabilities. When the transferee paid the cash and assumed the trade accruals the transferee would have incurred an expenditure with regards to the cash expended and the unconditional obligation regarding the trade creditors assumed. That said, in relation to the separately identifiable contingent liabilities there will be uncertainties in relation to the incurral of an expenditure as they are still subject to certain conditions.

Consequently, the transferee has not expended or unconditionally undertaken to expend cash or any other payment in kind. Said differently, the expenditure has not been incurred by the transferee in relation to the assumption of separately identifiable contingent liability on the date that the sale is concluded. The transferee however simply undertakes to incur an expenditure in future when the conditions attendant to the contingent liabilities are fulfilled. Therefore,

[138] SARS Interpretation Note 94 2016:22
[139] SARS Interpretation Note 94 2016:14

if, for example, the purchase price of a depreciable capital asset in the context of a going concern is R100 million and it is settled by the transferee paying R60 million in cash and assuming a free-standing contingent liability of R40 million, on the date of sale the transferee would potentially be entitled to an allowance calculated on an amount of R60 million. The amount of R40 million does not qualify for an allowance on the date of sale. In the event that the separately identifiable contingent liability materialises and the transferee will be deemed to have incurred an expenditure of R40 million and thus the R40 million will potentially qualify for an allowance.

Comments: The analysis performed in this report is consistent with the SARS's view regarding the conclusion reached in respect of the transferee.

Overall Analysis of Interpretation Note 94

Currently, as Interpretation Note 94 stands, neither the transferor nor the transferee gets a deduction for the contingent liability as it becomes unconditional. To elaborate on this, the example as set out above will be used. In terms of the example, the transferor sold the business comprising of an asset – motor vehicle (R100 million) – liabilities – trade accruals (R10 million), and contingent liabilities - leave pay provision (R25 million) and bonus provision (R5 million) – assumed by the transferee. Simplistically speaking, the motor vehicle is an allowance asset indicating that a total deduction of R100 million could potentially be obtained. Secondly, the leave pay provision (R25 million) and bonus provision (R5 million) could also result in a total deduction of R30 million once the qualifying criteria are met. This would follow that effectively, a total deduction of R130 million should potentially be obtained by either the transferor or the transferee.

The transferor in terms of Interpretation Note 94 does not qualify for a deduction with regards to the leave pay provision and bonus provision forgone. The transferee qualifies for a total deduction of R100 million i.e. the initial deduction in respect of the allowance on base cost of R70 million (cash of R60 million and trade accruals of R10 million) and the subsequent deduction upon the incurral of the contingent liability (leave pay provision of R25 million and bonus provision

of R5 million). This will imply that the transferee will be entitled to a total deduction of R100 million. Neither the transfer nor the transferor gets a deduction for the R30 million.

Conclusion on Interpretation Note 94

Interpretation Note 94 makes a valuable contribution with respect to understanding the income tax complications that could arise if there is a reduction in the purchase consideration of the an asset and such reduction is purely motivated by the assumption of separately identifiable contingent liabilities. The basis for the inclusion of the value of the contingent liability in the transferor's gross income or proceeds is not convincing. The total disregard for section 24M of the Act in Interpretation Note 94 also comes across as surprising.

Currently as it stands now, neither the transferor nor the transferee may get a deduction when the contingent liabilities become unconditional as illustrated above. Cloete JA in delivering the judgment in the *Ackermans* case stated the following:

> ..It was submitted on behalf of the respondent that unless the three contingent liabilities were allowed as a deduction in the hands of Ackermans, an anomaly would arise as they would never be deductible. The argument is without foundation. There would be no bar to Pepkor deducting the liabilities as and when they became unconditional, as counsel representing the Commissioner rightly conceded.

These comment were made in *obiter dictum* but the question arises as to whether Cloete JA was referring to – with respect to the example – the transferee getting a deduction for the leave pay provision of R25 million and bonus provision of R5 million in addition to the total allowance of R100 million. This question remained unanswered as it was not the case being decided upon.

Chapter 7: Recommendation & Conclusion

Over the last few years, there has been a constant effort by the SARS to address the income tax consequences attributable to the transferor including the transferee in the event that the acquisition cost of an asset acquired as a going concern is concluded or partly conclude by the takeover of separately identifiable contingent liabilities. This effort started with the issue of erstwhile Binding Class Ruling 029, issued by the SARS on 10 May 2011 regarding the deductibility of contingent liabilities taken over when buying the assets and liabilities of another company within the same group of companies. In this Binding Class Ruling, the SARS concluded that the transferee will be entitled to deduct contingent liabilities once incurred under section 11(*a*) read with section 23(*g*) of the Act. The SARS also issued Binding Private Ruling 185 on 11 December 2014 in respect of disposal of assets and liabilities, including contingent liabilities, as part of a group restructure. This binding private ruling dictated that expenditure incurred in relation to the contingent liabilities transferred to the transferee, will be deductible in the hands of transferee provided that the requirements of section 11(*a*) read with sections 23(*g*) and 7B are met at the time when the contingent liabilities materialise.

Both the Binding Class Ruling and Binding Private Ruling favoured the transferee to deduct the contingent liabilities as and when such liabilities become unconditional.

Subsequently, the SARS issued Interpretation Note 94 to provide clarity on income tax consequences that could arise if the consideration price of assets acquired as a going concern is reduced and the reduction is purely motivated by the assumption of contingent liabilities. A detailed analysis as performed in this report indicates that neither the transferee nor the transferor gets a deduction of the contingent liability as and when such contingent liability becomes unconditional. Whereas Interpretation Note 94 seeks for the transferor to include the contingent liability forgone in its gross income or proceeds as applicable.

Interpretation Note 94 therefore does not appear to resolve the uncertainties around the assumption of contingent liabilities as part of a sale of business although it provides meaningful contribution to the topic.

Furthermore, Interpretation Note 94 only considered Method One with regards to some of the ways for the assumption of contingent liabilities as part of a sale of business. It did not provide guidance on the methods for the transfer of contingent liabilities and the corresponding income tax implications.

Recommendation

The uncertainties around the income tax implications that could arise where there is a reduction in purchase consideration of an asset acquired as a going concern and that reduction is motivated by the assumption of separately identifiable contingent liabilities of assets should be of concern to taxpayers. Taxpayers need to be mindful when entering into such transactions. They should clearly state how the purchase consideration should be split between the assets. Where the assumption of contingent liabilities could be avoided, taxpayers should explore such options.

Overall, the transferor being entitled to a deduction for the contingent liabilities gives a bit of tax equalisation to the whole transaction although this could be difficult in the current state of the Act. In the *Tornado Transport (EDMS) BPK v Kommissaris Van Binnelandse Inkomste* (1997),[140] the taxpayer was found to have expended expenditure in the production of income when reimbursing another party who had paid a creditor of the taxpayer. The latter was allowed a deduction although it had not paid the creditor for incurred expenditure directly. This may present an argument for the transferor claiming a deduction when it technically reimburses the transferee for undertaking to pay its creditors and employees. This will be on the basis that paying the transferee to assume the contingent liability, the transferor has essentially paid the employees in the first instance. This will satisfy the requirements of section 7B of the Act.

[140] 62 SATC 373

The recommendation will be for the enactment of a new section into the Act to allow for a deduction by the transferor, an amount equal to the contingent liability that the transferee would assume.

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