# "Expenditure"

By Marvan Beukes [BKSMAR008]

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Faculty of Law

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Supervisor: Dr. Tracy Gutuza

## ABSTRACT

This dissertation endeavours to analise the case *Commissioner for the South African Revenue Service v Labat Africa Ltd* and its consequences in order to conclude whether the tax law created by the court is sound.

Specifically it looks at the progression of the case through the different courts, as well as the other court cases referred to in the different courts.

The research found that the case defined, for the first time, the term "expenditure" for South African Income Tax purposes.

It also found that the new definition may have created consequences for the interpretation of other sections of the Income Tax Act.

**DECLARATION**

I, Marvan Beukes, hereby declare that the work on which this dissertation is based is my original work (except where acknowledgements indicate otherwise) and that neither the whole work nor any part of it has been, is being, or is to be submitted for another degree in this or any other university.

Signature: Signed by candidate

Date: 17/2/2014

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## Chapter 1 - Introduction and problem statement

By default, most expenses claimed by taxpayers in some form of business in South Africa forms part of its net profit calculation and are therefore "expenditure" as anticipated by accounting standards.

The Conceptual Framework of Financial Reporting (December 2010) prescribes the following for the recognition of expenditure:
"Expenses are recognised... when a decrease in future economic benefits related to a decrease in an asset or an increase of a liabilty has arisen..."[1]

This often gives rise to tax disputes, as, in terms of the The Income Tax Act, No. 58 of 1962, as amended ("The Income Tax Act"), a taxpayer is taxed on the difference between its gross accruals and receipts and only those deductions that are allowed under the income Tax Act, as interpreted according to the usual legal principles.

The expression 'expenditure actually incurred' as found in various sections of the Income Tax Act has been the subject of various court cases. Up to ITC 1783[2], however, none of these cases dealt with the meaning of "expenditure" but rather with the question of when the expenditure was actually incurred. The Edgars Stores-[3], Nasionale Pers-[4] and Golden Dumps[5] cases emerged as the most important judgements in this regard.

The word "expenditure" is found maybe most famously in section 11(a) and section 11(gA), which allows a deductions of "expenditure ... actually incurred" (along with several other requirements). The word "expenditure" are also referred to in other sections in the Income Tax Act, for instance paragraph 20(1)(a) of the Eighth Schedule and the new section 40CA which became effective on 1 January 2013.[6]

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[1] International Accounting Standards Board: Conceptual Framework of Financial Reporting 2010
[2] ITC 1783[2004] 66 SATC 373
[3] Edgars Stores Ltd v Commissioner of Inland Revenue 1988 (3) SA 876 (A) at 888G-889C and 885A-B
[4] Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste 1986 (3) SA 549 (A) at 564A-C
[5] Commissioner for Inland Revenue v Golden Dumps (Pty) Ltd 1993 (4) SA 110 (A)
[6] Inserted by section 71(1) of Act 22 of 2012

From time to time companies issues shares, rather than pay cash, as consideration for the acquisition of assets or the procurement of services. The question arises whether this type of share-based payments[7] may be regarded as "expenditure" in determining the income tax consequences of the transaction.[8] This question eventually lead the court to define "expenditure" for purposes of the Income Tax Act - on 28 September 2011 the Supreme Court of Appeal gave its verdict in Case No 669/10, Commissioner for the South African Revenue Service v Labat Africa Ltd[9]. The case has far-reaching consequences, as it is the first time a South African court has determined the meaning of the term "expenditure".

The court unanimously found that where a company acquires assets through a share issue, it has not incurred "expenditure" for purposes of the Income Tax Act, as the term is not defined and that the ordinary meaning must be attributed to it and which it held was:

*"...the action of spending funds; disbursement or consumption; and hence the amount of money spent."* and *"...Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of the assets of the person who expends."*

As there is no diminution of the assets of a company when shares are issued, no "expenditure" was incurred by the company.

The finding may be perceived to be controversial, as some argue that it is not necessarily the incurrence of expenditure that causes a diminuation or movement the assets of the person who expends, but rather the settlement of the obligation that arises as a result thereof.

This mini-dissertation seeks to analise the case and its consequences in order to conclude whether the tax law created by the court is sound.

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[7] Terminology used by De Swardt in "Do share-based payments made for the procurement of services qualify as actually incurred?" *De Jure* 475

[8] Jansen van Rensburg, E.C. Some thoughts on the meaning of "expenditure" in the Income Tax Act *Tydskrif vir die Suid-Afrikaanse Reg*, 2013 Issue 1

[9] CSARS v Labat (669/10) [2011] ZASCA 157 74 SATC 1

Chapter 2 - ITC 1783

Before Labat, the concept (as referred to in section 11(gA)) was considered for the first time by the Gauteng Tax Court in ITC 1783, where the taxpayer tried to deduct a share-based payment: [10]

On 31 October 1995 the appellant acquired part of the sellers business. An agreement provided a method whereby the value of the assets acquired would be fixed and it was agreed that the purchaser would allot and issue to the seller in discharge of the value of such assets ("the purchase price") such number of ordinary shares in its capital, to be issued at par plus a premium, as would result in the seller holding that proportion of the entire issued share capital of the purchaser as the purchase price had to the total value of the purchaser's assets inclusive of the acquired assets. After the transaction was given effect to the seller became the holder of 30% of the issued share capital of the appellant.

The purchaser claimed a deduction in terms of section 11 (gA) of the Income Tax Act in respect of the expenditure incurred in purchasing the business. The Commissioner disallowed the deduction and contended that the taxpayer had not incurred any expenditure as contemplated in section 11 (gA) because the consideration given consisted of shares issued.

Goldblatt J defined "expenditure" as "the spending of money or its equivalent eg time or labour and a resultant diminution of the assets of the person incurring such expenditure". Goldblatt relied on a paragraph in *Silke on South African Income Tax* where the authors made the following statement:

*" It is submitted that the word 'expenditure' is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash. For example, if a merchant were required to pay for his goods by tendering land or shares in a company, the value of the land or shares would constitute expenditure in terms of s 11 (a) and would be deductible. If a merchant were to buy his goods in the United States at a price fixed in dollars, the liability so contracted would be 'expenditure' and would have to be brought to account at its equivalent in South African Currency.*

[10] ITC 1783[2004] 66 SATC 373

*An interesting point arises when a company discharges an obligation by the issue of its own shares. For example, a company may remunerate one of its employees for services rendered by the issue of its own shares. Since the company has not lost or parted with any asset, it is submitted that it has not expended anything, and that it is not entitled to claim as a deduction from income the nominal value of the shares issued to the employee. The position, it is submitted, would be different if the employee agrees to work for a salary payable in cash but subsequently decides to subscribe for shares and uses the remuneration owing to him to pay for the shares. In such a situation the company will have incurred expenditure comprising the salary due, notwithstanding the fact that its obligation is subsequently discharged by the issue of shares. But when a company is obliged to allot shares in return for services rendered to it, there is no laying out or expending of any of its moneys or assets which, it is submitted, is an essential requisite of the words 'expenditure actually incurred' in s 11 (a). A similar problem arises when a company allots shares in return for trading stock.*

*Whatever the strict legal position may be in relation to a company that discharges an obligation by the issue of its own shares, SARS is prepared in practice to allow as a deduction from the income of the company the nominal value of the shares it issues. While the recipient will be liable to tax on the value of the shares issued when they are issued in return for services rendered, the company will in practice be allowed a deduction of an amount equivalent to the nominal value of the shares issued."*[11]

The discussion in the textbook gave no authority for its view and the Commissioner's representitive denied at the hearing that it was SARS's practice to treat the issuing of shares as expenditure. No evidence was led by the taxpayer in this regard.[12]

The court's decision were criticised by various commentators:

- Ger argued that expenditure are being incurred when shares are issued to pay for services[13]

[11] Silke on South African Income Tax ("Memorial Edition") par 7.4

[12] Jansen van Rensburg, E.C. Some thoughts on the meaning of "expenditure" in the Income Tax Act *Tydskrif vir die Suid-Afrikaanse Reg*, 2013 Issue 1

[13] Ger, B. The problem of paying with shares *De Rebus*, September 2004

- Meyerowitz argued that under the old Companies Act, a company had to receive quid pro quo in cash or otherwise of not less than the value of the shares issued, so it follows that the company issueing the shares incurred cost through set-off that is at least equal to the value of the shares.[14]

- Burt was of the opinion that the court's view of "expenditure actually incurred" was too limited in the absence of any legal precedent. He argued that "expenditure" would have been incurred if an unconditional legal obligation in terms of which some form of performance is due has been incurred, provided that the performance due has a monetary value - the incurral of the legal obligation as a fact cannot be affected by the means by which that obligation is discharged.[15]

The Tax Court's judgement did, however, not constitute legal precedent, as it is not a court of law in the strict sense of the word, merely a court of review. [16] In other words, the Tax Court merely has the power to review and re-determine the correctness of the Commissioner's assessment of a particular taxpayer in a particular year.[17]

Following the Court's decision in ITC 1783, the Commissioner issued a Draft Interpretation Note[18] stating his view that the issuing of shares to settle a cost price or services does not constitute "expenditure incurred". This view was confirmed later in the Explanatory Memorandum issued in 2004.[19]

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[14] Meyerowitz, D. 2004 Paying for goods and services by issuing shares *The Taxpayer* Volume 86 p 87
[15] Burt, K. 2004 "Issuing shares as consideration – Expenditure actually incurred?" *Tax Planning* p 136
[16] CIR v City Deep Ltd (1924), 1 SATC 18
[17] Integritax Issue 103, March 2008 – License fees. Available online:
http://www.saica.co.za/integritax/2008/1612_Licence_fees.htm

[18] South African Revenue Service: Draft Interpretation Note issued 16 March 2004
[19] Explanatory Memorandum on the Revenue Laws Amendment Bill, 2004

## Chapter 3 - Labat

Marais[20] speculates that the reason why the Interpretation Note never was finalised, may have been that there was no need for it following the pronouncement in Labat by the Supreme Court of Appeal, as High courts and tax courts are obliged to follow legal interpretations of the SCA until the SCA itself decides otherwise.[21]

The Labat-case followed ITC 1783 and had the following facts:

The taxpayer, under its former name of Acrem Holdings Ltd, purchased 'the entire business operations' of Labat-Anderson (South Africa) (Pty) Ltd in terms of a written agreement dated 15 February 1999. Its effective date was 1 June 1999. The business operations of Labat-Anderson were defined to include all its tangible and intangible assets including, more particularly, the trade mark. In terms of clause 6 of the agreement, under the heading 'sale', the taxpayer 'purchased' the business 'for a consideration' of R120 million, 'discharged by the issue to Labat-Anderson' of 133 333 333 Acrem shares 'at an issue price of 90 cents per share'. (Although called a sale, the agreement was not a sale because a sale requires payment in money and not consideration in kind.) The clause further provided that the 'purchase price' was to be apportioned as to the net tangible assets at the values reflected in the accounts, then to the value of the trade mark and name in an amount as determined by an independent and suitably qualified valuator, and the balance was to be apportioned to goodwill.

An increase and subdivision of the authorized share capital of the taxpayer was necessary in order to create these shares. The terms of the agreement were approved and the necessary special resolutions were taken to give effect to the transaction. The shares were issued and transferred in terms of the agreement and their value, at the time of transfer, was in excess of the issue price. The trade mark was valued at R44 462 000 and the allowance claimed was based on this valuation. Its correctness was not in dispute.

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[20] Marais, A. The (In)equity of Labat, *The Taxpayer* January 2013

[21] *Ex Parte Minister of Safety and Security: In re S v Walters* 2002 (7) BCLR 663 (CC)

As in ITC 1783, the purchaser's claim for a deduction in respect of the value of the shares were denied by the Commissioner, since the Commissioner argued that the taxpayer did not incur "expenditure". The taxpayer appealed to the tax court. The sole issue between the parties was whether, within the context and meaning of the statutory provision, 'any expenditure' had 'actually' been 'incurred' by the taxpayer in the 2000 tax year.

Special tax court

The special court found that the issuing of the shares with a value equal to the value of the trade mark meant that the taxpayer did actually incur expenditure in obtaining assignment of the trade mark.[22] Jooste AJ held that ITC 1783 was "clearly wrong".[23]

Referring to Edgars Stores Ltd v CIR at 888G-889C and 885A-B, the court found that the expression 'expenditure actually incurred' means that the taxpayer must have incurred an unconditional legal obligation in respect of the amount concerned; it is not required that the obligation be discharged: once the obligation has been incurred, the expenditure becomes deductible. [24]

In trying to answer the question whether the issue of a company's own authorized share capital in exchange for the trade mark represents real consideration given by the company, the court referred to three English judgments that dealt with the effect of a transaction in terms of which a company acquires assets 'in consideration' of the issue of fully-paid shares: Osborne v Steel Barrel Co Ltd[25]; Craddock v Zevo Finance Co Ltd[26] and Stanton (Inspector of Taxes) v Drayton Commercial Investments Co Limited.[27] The impact of these cases are discussed in the Chapter 4 – Analyses of Labat.

[22] ITC 1801 [2005] 68 SATC 57
[23] Par 24 of the judgemend
[24] Edgars Stores Ltd v Commissioner of Inland Revenue 1988 (3) SA 876 (A) 50 SATC 81
[25] [1942] 1 All ER 634 (CA)
[26] [1944] 1 All ER 566 (CA)
[27] [1982] 2 All ER 942 (HL)

North Gauteng High Court

On appeal to the North Gauteng High Court gave a short judgment on 11 December 2009 upholding the decision of the Gauteng Special Income Tax Court.[28]

Although the Tax Court's judgment touched on a number of issues the only issue before the court was whether the issue by a company of its own authorised capital in exchange for a trademark represents real consideration given by the company for the purposes of Section 11(gA) of the Income Tax Act.

Counsel for SARS argued that the use of the word "deemed" in the amended section 84 was an indication that but for the deeming section such issue of shares would not constitute expenditure. [29] The court dismissed this: *"This argument is not convincing and does not help us either way in deciding the issue before us."*

Sapire AJ mentioned the fact that Goldblatt J found support for his views in paragraph 7.4 of Silke South African Income Tax: *"The Judge a quo observed that a perusal of the passage in question reveals that the writer cited no authority for the statements made therein."*[30]

Supreme court of appeal

The Commissioner appealed to the Supreme Court of Appeal and on 28 September 2011 it gave its verdict, ruling that the issuing of shares by a company as consideration for the acquisition of assets does not constitute "expenditure" for purposes of the act. [31]

Marais[32] notes that the Supreme Court's verdict to overturn the decision of the High Court is controversial, for the following reasons:

[28] CSARS v Labat Africa Ltd [2009] 72 SATC 75
[29] Section 84 of the Income Tax Act, amended by section 46 of Act 30 of 2000 and by section 56(1)(a) and (b) of Act 60 of 2001 and repealed by section 271 of Act 28 of 2011
[30] Par 3
[31] CSARS v Labat (669/10) [2011] ZASCA 157 74 SATC 1
[32] Marais, A. The (In)equity of Labat, *The Taxpayer* January 2013

- The court overturned the judgement of a Full Bench of the North Gauteng High Court
- The said Full Bench was of the opinion that the Commissioner had no reasonable prospect of success on appeal[33] and refused the Commissioner's application for leave to appeal to the Supreme Court of Appeal
- It was only with special leave from the SCA that the matter was heard by the court and the judgement subsequently overturned.

**Analyses of the Labat judgment**

Expenditure

In paragraph 12 of his judgment, Harms AP discusses and defines the term "expenditure" as follows:
*"The term 'expenditure' is not defined in the Act and since it is an ordinary English word and, unless context indicates otherwise, this meaning must be attributed to it. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. The Afrikaans text, in using the term 'onkoste', endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter-performance may be the same or even more than the value expended."*

Harms critisized the tax court for relying on Edgars Stores which was based on Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste, as although the court stated the principle to be deduced from these judgments correctly the problem was that they did not deal with the meaning of 'expenditure' but with the question when the expenditure was actually incurred. Harms noted that it was never an issue as to when liability arose. The transfer of the shares took place against the

[33] at 4F, par [2]

assignment of the trade mark and the taxpayer sought to claim the allowance in the year the obligation was incurred.

Harms suggests that the court tried to answer the wrong question:
*"The question the court should have posed was whether the issuing of shares by a company amounts to 'expenditure' and not whether the undertaking to issue shares amounts to an obligation, which it obviously does. The terms 'obligation' or 'liability' and 'expenditure' are not synonyms. This is apparent from what was said by Botha JA in Caltex Oil (SA) Ltd v Secretary for Inland Revenue 1975 (1) SA 665 (A) at 674D-E, namely that the expression 'any expenditure actually incurred' means 'all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not'.*
*In other words, the liability or obligation must be discharged by means of expenditure – timing is not the question."*

Harms's remark that *"the liability or obligation must be discharged by means of expenditure – timing is not the question"*, brought one of the main arguments against his judgment into the spotlight:

Burt contended, even before Labat was settled by the SCA, that *"expenditure will have been incurred if an unconditional legal obligation in terms of which som form of performance is due has been incurred, provided that the performance due has a monetary value. The incurral of the legal obligation as a fact cannot be affected by the means by which that obligation is discharged."*[34]
and
*"The crucial question is ... whether the term "expenditure actually incurred" envisages anything other than the incurral of an unconditional legal obligation in terms of whichsome form of performance is due, provided that the performance due has a monetary value."*[35]

Emslie argues that Harms has put the cart before the horse: *"an expenditure must first exist before it can be "actually incurred" and that "expenditure actually incurred"*

[34] Burt, K. 2004 "Issuing shares as consideration – Expenditure actually incurred?" *Tax Planning* 2004
[35] Burt, K. 2006 "Issuing shares as consideration – II ITC 1801 v ITC 1783" *Tax Planning* 2006

*refers to the coming into existence of an absolute and unconditional legal liability. Thus expenditure does not discharge a liability or obligation; rather, expenditure gives rise to a liability or obligation..."*[36]

To support his argument, he refers to PE Tramways v CIR, where Watermeyer AJP said that: *"...expenses "actually incurred" cannot mean "actually paid"..."*,[37] as well as Concentra v CIR where Howes J remarked that: *"If a taxpayer because of shortage of funds could postpone the payment of liabilities incurred and by doing so take them out of the year of assessment for income tax purposes the entire system of taxation would be affected."*[38] According to Emslie, this means that, as expenditure must be deducted in the year in which it is actually incurred and cannot be deferred until the year in which payment is made, expenditure is incurred before it can be discharged, contrary to what Harms has said.

Emslie are of the opinion that Harms's quote of Botha JA in Caltex Oil v SIR in paragraph 8 of his judgement, ("*The expression "expenditure actually incurred" in section 11(a) does not mean expenditure actually paid during the year of assessment, but means all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not.*"), contradicts his argument that *"the liability or obligation must be discharged by means of expenditure – timing is not the question"*.

Emslie summarises the meaning attributed by Harms AP to the word "Expenditure" as follows:

1. The word "expenditure", contrary to what may appear to have been held by Harms AP, refers to a contractual (or other legal) obligation to spend money or to disburse other assets with a monetary value.
2. Such expenditure is "actually incurred" in the year in which a taxpayer's liability in terms of such obligation becomes absolute and unconditional.
3. And such liability is discharged, not by the expenditure, but by the payment or disbursement of assets with a monetary value which extinguishes that liability.

[36] *The Taxpayer*, Volume 60, September 2011: Commissioner for the South African Revenue Service v Labat Africa Limited Supreme Court of Appeal, 28 September 2011
[37] Port Elizabeth Tramway Co Ltd v Commissioner for Inland Revenue 1936 CPD 241 8 SATC 13 at par 244
[38] Concentra (Pty) Ltd v Commissioner for Inland Revenue 1942 CPD 509 12 SATC 95 at par 513

I am of the opinion that Emslie's argument is not valid after the Labat judgement, as Harms's judgment dismisses the argument that expenditure is the cause of the liability or obligation and not the means of discharging it.

Subsequent to the SCA case, Carney, from the Department of Afrikaans and General Literature Science at UNISA, anlysed the word "onkoste" ("expenditure") semantically using Shuy's (1986) model, in order to establish whether the court understood the word correctly and applied its meaning correctly in its judgment.[39]

With regards to the different judges all referring to the "ordinary meaning" of "expenditure", he assumes that with "ordinary meaning" they are referring to the dictionary meaning and he makes the following observations:

1. It is uncertain whether the different judges understood correctly the literally meaning of the word "expenditure"
2. He critisises the fact that a preciding judge will make use of only a dictionary to find the ordinary meaning of a word, as dictionaries are limited to only describe certain fassets of a word's meaning.
3. It is uncertain which dictionaries the judges consulted, and if they have consulted any dictionaries at all.

Carney is critical of both the judges in the tax court (Goldblatt, later quoted by Sapire in the High court) and the SCA (Harms), as they both insisted that the word "expenditure" must be given its ordinary meaning, but then went on to make up their own definitions.

Carney distinguishes between two definitions of "expenditure" transpiring from the judgements, namely the Goldblatt-definition and the Harms-definition.

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[39] Carney, T.R. (2012): 'n Forensies-semantiese beskouing van die woordgebruik "onkoste" in die hofsaak Commissioner for the South African Revenue Service v Labat Africa Limited, *Southern African Linguistics and Applied Language Studies*, par 30:4, 487-496. Available online: http://dx.doi.org/10.2989/16073614.2012.750822

According to him, Goldblatt defines "expenditure" as *"The spending of money or its equivalent, time or labour for example and the resultant diminution of its assets of the company making the expenditure".*[40]

Harms defines "expenditure" as *"Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. [...] Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movements of assets of the person who expends."*[41]

The result of Carney's analysis is that a diminution does form part of an extended understanding of the word "expenditure", but that a semantic analysis is necessary to indicate this semantic relationship. No dictionary (standard or technical) explicitly defines the word to include diminution. This means that dictionaries are lacking in their scope and authority, especially where the context of the lawsuit is important. Though the judges' interpretation of the word was correct, it was context specific, and therefore not an "ordinary word".

Carney further suggests that linguists or language experts be consulted by law practitioners in matters of legal disputes where the dispute revolves around language. Alternatively, law practitioners should have a stronger linguistic background in order to solve complex language problems as necessary.[42]

Foreign judgments

The Special Tax Court considered three foreign cases in its judgment. The first case was Osborne v Steel Barrel Co Ltd.[43]

In this case the assets acquired was held as trading stock. The question was raised whether an amount could be included in the opening balance of the acquired trading stock and the question was decided by the court of appeal in favour of the taxpayer in that the issue of shares for the acquisition of assets amounted to 'consideration'

[40] Sapire, 2009: 2-3 72 SATC 75
[41] Harms, 2011: 5-6 74 SATC 1
[42] ibid
[43] [1942] 1 All ER 634 (CA)

given by the company. Lord Greene MR argued that, by giving up its right to demand payment for the shares issued, the company has not acquired the assets for nothing:

*"It was strenuously argued on behalf of the crown that, if a company acquires stock in consideration of the issue of fully-paid shares to the vendor, that stock must, for the purpose of ascertaining the company's profits, be treated as having been acquired for nothing... The argument really rests on a misconception as to what happens when a company issues shares credited as fully paid for a consideration other than cash. The primary liability of an allottee of shares is to pay for them in cash; but, when shares are alloted credited as fully paid, this primary liability is satisfied by a consideration other than cash passing from the allottee. A company, therefore, when in pursuance of such a transaction, it agrees to credit the shares as fully paid, is giving up what it would otherwise have had – namely, the right to call on the allottee for payment of the par value in cash."*[44]

Harms notes that the applicable statutory provision was not identified in Osborne v Steel Barrel and that there is no indication that the statute used the term 'expenditure'. The court decided that the issue of shares for the acquisition of assets amounted to 'consideration' given by the company and established on what principle the value of the acquired assets had to be ascertained. He dismisses the case by remarking that *"how it bears on the question whether the issue of shares amounts to 'expenditure' I do not understand."*[45]

The next foreign case considered was Craddock v Zevo Finance Co Ltd.[46]
In this case the assets acquired was held as trading stock. It was held that a deduction equal to the par value of the shares were appropriate, rather than the value of the shares.

Lastly the court looked at Stanton (Inspector of Taxes) v Drayton Commercial Investments Co Limited.[47]

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[44] 637G – 638A
[45] at par. 10
[46] [1944] 1 All ER 566 (CA)
[47] [1982] 2 All ER 942 (HL)

In this case the assets acquired was held on capital account. The shares were not issued at par, but at a premium (in terms of the agreement). On appeal the value of the shares themselves was held as deductible.

It is important to note that legislation dealing with corporate tax on capital gains was under consideration at the time of the Stanton-case, which allowed for a deduction equal to the "consideration" that was "given", rather than a deduction equal to the taxpayer's "cost" and since the concepts of "cost" and "consideration" are different, care should be taken when applying the judgment in the Stanton-case to legislation which do not use similar concepts.[48]

Harms dismissed both the Craddock- and the Stanton cases, noting that *"it escapes me how these decisions have any bearing on the meaning of 'expenditure' as used in s 11 of the Act."*[49]

Harms was correct to attach no weight to the United Kingdom cases in Labat. In the United Kingdom, a company is taxed on its "profits"[50], which is determined in terms of commercial accounting principles.[51]

"Profits" is defined as follows*: "Profits are ascertained by setting against the income earned the cost of earning it"* [52]
and
*"The profit of a trade or business is the surplus by which the receipts for the trade or business exceeds the expenditure".*[53]

There is thus no need for a "general deduction formula" under the United Kingdom legislation; instead, all the taxpayer's cost that are relevant for determining its profits are taken into account, unless there is a specific prohibition against the deduction of a particular cost. In South Africa, on the other hand, a company is taxed on the

[48] Jansen van Rensburg, E.C. Some thoughts on the meaning of "expenditure" in the Income Tax Act *Tydskrif vir die Suid-Afrikaanse Reg*, 2013 Issue 1
[49] at par. 11
[50] Section 35 of the Corporation Tax Act, 2009
[51] Tiley (2005) *Revenue Law*
[52] Gresham Life Assurance Society v Styles 1892 AC 309 321
[53] Russell v Aberdeen Town and Country Bank (1887) 2 TC 321 327

difference between its gross accruals and receipts and only those deductions that are allowed under the income Tax Act, as interpreted according to the usual legal principles. Jansen van Rensburg notes that, out of the three cases, only Osborne case may be helpful, as it considers whether a share-based payment constitute "cost", and "cost" is arguably a concept which has similarities with that of "expenditure". [54] His argument seems to be supported by the two definitions of "profit" in the previous paragraph, where the two terms are used interchangeble.

Diminution of assets

After Harms laid down the "diminution of assets"-requirement, it is necessary to establish whether there was any diminution or movement of Labat-Africa's assets.

An argument that may be raised in favour of regarding share-based payments as "expenditure", is the following: When a taxpayer agrees to make a share-based payment, it forgoes its right to claim cash. And, since the right so forgone constitutes a diminution of the assets of the taxpayer, it constitutes "expenditure" by the taxpayer.[55]

To answer the question, the legal characteristics of both shares and assets are relevant:

The applicable legal characteristics of shares are the following:[56]
Shares are usually regarded as a complex of personal rights, for example the right to participate in the company's distributions, but it do not include a right of ownership in the company's assets.[57] Prior to shares being issued, shares are not the property of the issuing company.[58] The issue of shares does not constitute the transfer by the company of its property.[59] A company is not obliged to issue shares for cash. (As Harms pointed out in his judgment in paragraph 13, at the relevant time the

[54] Jansen van Rensburg, E.C. Some thoughts on the meaning of "expenditure" in the Income Tax Act *Tydskrif vir die Suid-Afrikaanse Reg*, 2013 Issue 1
[55] n 54
[56] ibid
[57] Cassim et al (2011) *Contemporary Company Law*
[58] Pilmer v Duke Group Limited (In liquidation) 207 CLR 165 par 20
[59] Ord Forrest (Pty) Ltd v Federal Commissioner of Taxation 74 ATC and Blackman, Jooste et al (2002) *Commentary on the Companies Act* par 5 – 255 Revision Service 6, 2009

provisions of the Companies Act 61 of 1973 applied. Section 93(2) allowed shares to be allotted otherwise than for cash). When a company agrees to issue its shares for consideration consisting of assets, the contract is not a barter transaction since the company does not agree to transfer property or anything else, but rather agrees to create the complex of personal rights that comprises the share.[60]

Harms is therefore correct when he says that: *"I have already noted that the agreement was not one of sale. The taxpayer, however, argued otherwise and referred to the fact that a money value had been placed on the shares."*[61] Technically it cannot be a sales contract, since the company is neither a purchaser (it does not agree to pay a monetary amount), nor is it a seller (it does not agree to transfer goods to the counter-party).[62]

In the caselaw that Harms cites, Lace Proprietary Mines Ltd v CIR, the taxpayer agreed to transfer mineral rights in return for the allotment and issue of shares in the buyer. The court interpreted the contract to be one for the issuing of shares and not for payment of a cash amount, since the company was obliged (as in Labat) to issue shares and not to pay the cash amount.[63]

The applicable legal characteristics of assets are the following[64]:
A person's "assets" (depending on the context) is often viewed as the person's patrimonial rights and the objects of these rights and may includes his statutory rights.[65] A person's patrimonial rights are regarded as the subjective rights to patrimonial objects which that person holds, i.e. it is the claims that a person has to legal objects with economic or material value as against other persons. [66] A number of different types of subjective rights are recognised, one of which are a "personal right", the object of which is performance. A "performance" is regarded as "an act in

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[60] Blackman, Jooste et al (2002) *Commentary on the Companies Act* par 5 - 255 Revision Service 6, 2009
[61] Par. 13
[62] n 54
[63] Lace Proprietary Mines Ltd v Commissioner for Inland Revenue 1938 AD 267 9 SATC 349
[64] n 54
[65] Benoni, Brakpan and Springs Board of Executors, Building Society and Trust Co Ltd v Commissioner of Inland Revenue 1921 TPD 170 173
[66] Van der Merwe "Things" XXVII *LAWSA* par 195 and Badenhorst et al (2006) *Silberberg and Schoeman's The Law of Property* 9 and 24

the form of delivering something, doing or not doing something which one person can require a particular other person to perform.[67]

Entering into a subscription agreement has the result that the company now has an asset, being its personal right to receive the subscription consideration. If the parties agreed that the consideration is in-kind (as in Labat), the company's only right is the right to that in-kind consideration, it has no right to a cash amount. The "right" of a company to receive cash as consideration for the issuing of its shares is not a personal- or any other type of subjective or statutory right of the company. The "right" that Lord Greene MR referred to in the Osborne-case can therefore not be an "asset" of the company in the legal sense of the word.[68]

I thus agree with Jansen van Rensburg's conclusion[69] that, if the word "asset" in Harms's definition of "expenditure is given its legal meaning, share-based transactions will not diminish the taxpayer's assets. Harms comes to the same conclusion in paragraph 14:
*"Labat-Anderson assigned the trade mark as consideration for the shares and the taxpayer did not 'expend' any money or assets in acquiring the trade mark. As Goldblatt J said in ITC 1783 (66) SATC 373, an allotment or issuing of shares does not in any way reduce the assets of the company although it may reduce the value of the shares held by its shareholders, and that it can therefore not qualify as an expenditure. It would have been more correct if he had said that it did not involve a shift of assets of the company even though it might, but not necessarily, dilute or reduce the value of the shares in the hands of the existing shareholders. If authority is needed for the self-evident statement of the learned judge that an allotment of shares does not diminish a company's assets, one may refer to Commissioner for Inland Revenue v Estate Kohler & others 1953 (2) SA 584 (A) at 593H and 600F which was followed by Estate Furman & others v Commissioner for Inland Revenue 1962 (3) SA 517 (A)."*

In the Kohler-case, Centilivres J stated:

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[67] Badenhorst et al (2006) *Silberberg and Schoeman's The Law of Property* 9 and 24
[68] n 54
[69] ibid

*"But when a company issue shares to an allottee, no property passes from the company to the allottee. The allottee acquires a right against the company, but the company does not part with any of its property."*[70]

De Swardt, however, argues that the "primary right" of a company to receive a cash subscription price could be regarded as a personal right against the allottee that would have been enforceable had the subscription agreement not provided for the subscription price to be settled in kind and thus an asset of the company. When a company issues shares for a consideration in kind, it gives up that personal right, and there is, accordingly, a diminution in its assets. He argues that the company's expenditure lies in forfeiture of the subscription price due by the subscriber.[71]

Harms also deals with the 'set-off' argument propounded on behalf of the taxpayer in the tax court: *"How one can set off shares against money was not explained. In any event, the full court said that if the agreement had been that Labat-Anderson would have purchased the shares at an agreed price and that the proceeds of the sale would be applied to the purchase price, there could be no doubt that the transaction would constitute an expenditure by the company of its share capital, and that it is difficult to see the difference between this construction and the present agreement. Whether or not the premise of the full court is correct, the conclusion misses the point. Because there is no suggestion that the contract is in any way simulated we have to take it as we find it. The fact that the parties may have constructed their agreement differently and tax-efficiently is entirely beside the point."*

Set-off takes place where parties are mutually indebted under obligations that are of a similar nature, usually to pay money.[72] In Labat, set-off would thus only have been possible if the purchaser had to pay cash for the assets, and the seller had to buy the purchaser's shares for cash.

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[70] Par 593H

[71] De Swardt 2008 "Do share-based payments made for the procurement of services qualify as actually incurred?" *De Jure* p 475

[72] Blackman, Jooste et al (2002) *Commentary on the Companies Act* par 5 – 255 Revision Service 6, 2009

Harms was also correct to reject the notion that the share-based transaction have the same economic effect as set-off, as the court has in the past, in considering the tax implication of a transaction, given effect to the transaction that was entered to in its legal nature.[73]

In paragraph 16 Harms dismissed critisism by Meyerowitz about the judgment of Goldblatt J in the tax court[74].

In paragraph 17 he also deals with the economic equivalence-argument: "*The taxpayer submitted that serious anomalies would arise if the allotment of shares is not regarded as expenditure. The first response could be that tax laws notoriously contain many anomalies and inconsistencies. The first inconsistency relied on is that the receipt of shares as consideration for the 'sale' of an asset 'is consideration in the hands of the seller for purposes of determining the seller's tax liability'. It would, said counsel, be incongruous to regard those shares as being 'consideration' in the hands of the seller but not as being consideration in the hands of the 'purchaser' for the same purposes. The problem, if there is one, is the result of the fact that 'gross income' is defined (as far as is relevant) as the total amount, 'in cash or otherwise', received by or accrued to or in favour of a local taxpayer but excluding accruals of a capital nature. We first have to assume that the accrual of the shares was not of a capital nature. If it was not, one moves to the definition of 'income' which is defined to mean the amount remaining of the gross income after deducting therefrom any amounts exempt from normal tax under a number of provisions, including s 11. The taxable income is not the difference between gross income and expenditure; and gross income is not limited to the converse of expenditures. Expenditure, to be deductible, must not be of a capital nature – and a trade mark is a capital asset. It is only because of the special dispensation that amortisation of the cost of acquisition of this capital asset is permitted. The equation (if there is one) is therefore much more complicated than suggested by counsel.*"

[73] Lace Proprietary Mines Ltd v Commissioner for Inland Revenue 1938 AD 267 9 SATC 349 at 279
[74] Meyerowitz, D. 2004 Paying for goods and services by issuing shares *The Taxpayer* Volume 86 p 87

A similar argument than the taxpayer's in Labat was previously rejected in the house of lords in Lowry (Inspector of Taxes) v Consolidated African Selection Trust Ltd (1940).[75]

In paragraph 18 Harms also rejects the taxpayer's argument that an anomily has arisen with the introduction of capital gains tax, something that happened after the tax year under consideration.

In summary, the verdict gives clarity on the legal interpretation of the phrase "expenditure actually incurred". The expenditure and the actually incurred refers to two, seperate requirements. The words "actually incurred" are important from a timing perspective, since, until such time a taxpayer is unconditionally and absolutely required to perform, no deduction is allowed. The word "expenditure" looks at the performance that is due, and if the performance will constitute a diminution of the assets of the taxpayer, a deduction may be claimed (provided all other applicable requirements have been met). [76]

[75] n 70
[76] n 70

## Chapter 4 - Other case law

On 1 October 2010, not long before the SCA's decision in the Labat-case, the SCA also handed down its verdict in the Ackermans-case.[77]

In the Ackermans case, the taxpayer has agreed to transfer its business as a going concern and, as consideration, the counter-party ("the purchaser") agreed to both pay a monetary amount and to assume some liabilties of the taxpayer. The result was that the taxpayer received less money for its assets than it otherwise would have had, had it not also assigned its liabilities. The taxpayer claimed as a deduction part of the monetary amount that it has forgone as part of the reduced monetary purchase price.

In support of its claim, it argued that "expenditure" includes all "actual, quantifiable diminutions or prejudicial effects suffered by the taxpayer's patrimony". It further argued that "expenditure" was not limited to those instances where there is a legal obligation owed to another, since the concept *"is an economic or commercial concept, rather than one related to strict law or obligations"*.

The argument was rejected by the Supreme Court of Appeal. Cloete JA held that a taxpayer can incur "expenditure" only if it has incurred a "liability to pay". And since the taxpayer never incurred a liabilty to pay the purchaser to assume the liabilities, no "expenditure" has been incurred.

That there are similarities between the arguments raised by the respective taxpayers in the Labat- and Ackermans cases becames apparent if one rewords the taxpayer's argument in the Ackermans case as follows: the taxpayer had the "right" to sell its business assets for cash by entering into the above-mentioned agreement, in terms of which it accepted as consideration both cash and the assumtion of its liabilities by the purchaser, it had partly forgone this "right". The forgoing of a "right" constitutes a diminution in the taxpayer's assets and thus "expenditure". By rejecting this argument, the SCA in the Ackermans-case is thus by implication also rejecting the

[77] Ackermans v Commissioner of the South African Revenue Service (441/09) [2010] ZASCA 131

argument that where the "asset" that is being "expended" is the opportunity to earn a monetary amount, it will constitute "expenditure".[78]

[78] Jansen van Rensburg, E.C. Some thoughts on the meaning of "expenditure" in the Income Tax Act *Tydskrif vir die Suid-Afrikaanse Reg*, 2013 Issue 1

## Chapter 5 - Subsequent events

Subsequent to the Labat judgment, section 24B(1) was inserted into the Income Tax Act .[79] The section deemed a company that acquires an asset as consideration for shares issued by the company to have incurred expenditure.

While Jansen van Rensburg was correct in deducing that the ambit of the Supreme Court of Appeal's decision was now less extensive than when the transaction in Labat took place[80], it should be noted that various commentators are of the opinion that section 24B(1) (now section 40CA – see below) may not be applicable where shares are issued in return for services.[81]

Section 24B was amended with effective date 1 January 2013 to be applicable where shares are acquired as consideration for shares issued by the company to a connected person in relation to that company and subsection (1) was deleted. Section 40CA was, however, inserted into the Act, also effective from 1 January 2013. The latter is effectively a substitute for section 24B(1) in that it states that if a company acquires an asset in exchange for shares issued, the company is deemed to have actually incurred expenditure equal to the market value of the shares issued.[82]

[79] Substituted by s39(1)(a) of Act 60 of 2008 and deleted by section 51(1)(b) of Act 22 of 2012

[80] Jansen van Rensburg, E.C. Some thoughts on the meaning of "expenditure" in the Income Tax Act *Tydskrif vir die Suid-Afrikaanse Reg*, 2013 Issue 1

[81] De Swardt 2008 "Do share-based payments made for the procurement of services qualify as actually incurred?" *De Jure* p 475; Silke 2005 "Expenditure actually incurred?" *Tax Planning* p 12-14; Burt, K. 2004 "Issuing shares as consideration – Expenditure actually incurred?" *Tax Planning* p 136

[82] Amendments in terms of Act 22 of 2012

Chapter 6 - Conclusion

With the meaning of the term "expenditure" now defined, it will be interesting to see what the consequences and applications thereof will hold for the future South African tax landscape.

The defintion may have found application in a number of cases, for instance, NWK[83]:

The facts of NWK was summarised by Lewis JA in paragraph 11 of the judgment as follows:

(a) A subsidiary of FNB that dealt in financial instruments, Slab, would lend a sum of R96 415 776 to NWK, to be repaid over five years.
(b) The capital amount would be repaid by NWK delivering to Slab at the end of the five year period 109 315 tons of maize.
(c) Interest would be payable on the capital sum at a fixed rate of 15.41 per cent per annum payable every six months. To this end NWK would issue ten promissory notes with a total value of R74 686 861.
(d) To fund the loan Slab would discount the notes (sell them for an amount less than their face value) to FNB. NWK, on due date, would pay FNB.
(e) Slab would sell its rights to take delivery of the maize at the end of the five year period to First Derivatives, a division of FNB. This 'forward sale', for the sum of R45 815 776, would enable FNB to pay the full amount of the loan to NWK.
(f) First Derivatives would sell to NWK the right to take delivery of the same quantity of maize for the sum of R46 415 776, payable immediately on the conclusion of the contract, but delivery to take place only five years hence. This contract would neutralize the risks associated with delivery in the future.
(g) Slab would cede its rights to a trust company to relieve Slab of the 'administrative burden' of the transaction. (This transaction did not eventuate.)

By applying the definition of "expenditure" as laid down in Labat, it is clear that the net diminution of NWK's assets is R 24 686 861 (the promissory notes of

[83] CSARS v NWK (27/10) [2010] ZASCA 168 (1 December 2010)

R74 686 861 less the difference between the loan amount (R 96 415 776) and the amount paid for the right to take delivery of the maize (R46 415 776), e.g. R 50 000).

This is also the conclusion the court arrived at, but by applying a much more controversial set of arguments.

Some other applications may be found in section 22 of the Income Tax Act.

For instance, in terms of sections 22(2A) of the Income Tax Act, where any person carries on any construction, building, engineering or other trade in the course of which improvements are effected by him to fixed property owned by any other person, any such improvements effected by him and any materials delivered by him to such fixed property which are no longer owned by him shall, until the contract under which such improvements are effected has been completed, be deemed for the purposes of this section to be trading stock held and not disposed of by him.

In terms of section 22(3A), the cost price of trading stock referred to in subsection (2A) shall be the sum of the cost to the taxpayer of material used by him in effecting the relevant improvements, and such further costs incurred by him as in accordance with generally accepted accounting practice are to be regarded as having been incurred directly in connection with the relevant contract, and such portion of any other costs incurred by him in connection with the relevant contract and other contracts as in accordance with generally accepted accounting practice are to be regarded as having been incurred.

The question that now arrives is, what if a person incur expenditure in terms of a contract similar to a contract anticipated in section 22(2A), but he does not carry on any construction, building, engineering or other trade in the course of which improvements are effected by him to fixed property owned by any other person?

For instance, an architecht, attorney or auditor may be involved in a project or have some work-in-progress where he/she is contractually entitled to claim back the time he/she and their staff had spent on the project.

Can it now not be argued, in terms of the Labat-principle, that although certain expenses have been paid (for instance salaries), no diminution of assets took place, as the time spent on the project has replaced the cash outflow with a right to claim from the client an amount equal or bigger than the cash outflow? Or will this replacement of one asset (cash) with another (the claim against the client) be the "movement of assets" that Harms had referred to?

Labat may well have created hidden consequences for certain sections of the Income Tax Act.

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