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WAS THE SUPREME COURT OF APPEAL CORRECT IN CSARS v LABAT?

RESEARCH PAPER (PG DIP in TAX LAW: CML5615W) by

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Chapter 1

Introduction

In the business world, more often than not companies pay for assets acquired or expenses incurred by giving up their right to something, such as an asset, or rendering services to the other party. Another way to pay for the acquisition of assets or expenses that is becoming popular in the business world today is by offering a stake of the company in the form of an issuance of shares in the company to the other party as payment. This situation, however, is not a clear-cut situation when it comes to calculating taxable income despite the fact that section 40CA of the Income Tax Act 58 of 1962¹ (hereinafter referred to as the ‘Act’) deals with one of these situations. Section 40CA (1) (a) as amended says the following:

“(1) Subject to section 24B, if a company acquires any asset as defined in paragraph 1 of the Eight Schedule, from any person in exchange for-

(a) Shares issued by that company, that company must be deemed to have actually incurred an amount of expenditure in respect of the acquisition of that asset which is equal to the market value of the shares immediately after the acquisition”

Section 40CA (1)(a) deals with the acquisition of an asset with the issuance of shares as payments. This provision of the Act only deals with such a situation, it does not deal with situations where services are rendered in exchange for shares issued and it also does not deal with other complex situations where a deeper understanding of this provision might be required.

However, even though this provision of the Act states that a company is deemed to have ‘actually incurred’ an amount of ‘expenditure’ in respect of acquiring an asset with a share

¹ Income Tax Act S 40CA inserted by s. 71 (1) of TLA Act of 2012 with effect from 1 January, 2013 and applicable in respect of acquisitions made on or after that date

based payment, the recent passed judgment of *CSARS v Labat Africa Limited*² makes the situation a bit more complicated. A taxpayer can use the general deductions formula or other specific deductions provisions in the Act to deduct this ‘deemed expenditure’ under relevant deduction provisions of the Act. The general deductions formula is basically section 11(a) read with section 23(g) as laid out in the Act. Section 11(a) of the Act says:

“General deductions allowed in determination of taxable income. 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-expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature”

Read with section 23(g) which limits the deduction of such ‘expenditure actually incurred’ to the extent that it is incurred for trade purposes. Section 23(g) reads:

“(23) No deduction shall in any case be made in respect of the following matters, namely –
(g) Any moneys, claimed as a deduction from income derived from trade, to the extent to which moneys were not laid out or expended for the purposes of trade”

In the past, there have been many cases dealing with the ‘actually incurred’ part of the gross deductions definition. Therefore, that part is properly understood to mean a taxpayer actually incurs an expense or loss when there is an unconditional legal obligation. The *Labat* case was a section 11(gA) case but the phrase ‘expenditure actually incurred’ is found in both section 11(gA) and section 11(a). Because a lot of deductions are deducted under section 11(a) - or as it is known, the general deductions formula - the research will be focused on section 11(a), mainly on the phrase ‘expenditure actually incurred’. Payments for services rendered, in most cases, meet the requirements of section 11(a) as well. It shall be assumed,

² *Labat Africa Limited, CSARS v, 74 SATC 1 (SCA), 2011*

for the purposes of this research, that all the other requirements of the general deductions formula are met by share based payments incurred for services rendered. The other requirements being: the taxpayer carries on a trade, the expense was incurred in the production of income and the expense is of a revenue nature.

The meaning of ‘expenditure actually incurred’ is correctly interpreted in *Nasionale Pers Bpk v KBI (Nasionale Pers)*³, *Edgars Stores Ltd v CIR (Edgars Stores)*⁴, *CIR v Golden Dumps (Pty) Ltd (Golden Dumps)*⁵ and a more recent case which is *Ackermans Limited v CSARS (Ackermans)*⁶. Some of these judgments were also used by the Income Tax Special Court in the ruling of *ITC 1801*⁷.

In the *Nasionale Pers Bpk* case, the taxpayer attempted to deduct expenditure when it was paid but there were still conditions to be met by the end of the year of assessment, if those conditions were not met by the parties that received the money, such moneys were to be refunded to the taxpayer. The obiter dictum of the case was that the legal liability arose outside the said year of assessment even though the payment of such expenditure had occurred in that year of assessment. Therefore, from this case, it was learned that a taxpayer should have an unconditional legal liability without any conditions present by the end of the year of assessment for that item to qualify as ‘expenditure actually incurred’ under section 11(a). The *Edgars Stores* case also had a condition to be met. The turnover rent (additional rent that was included in the lease agreement) was dependant on the amount of turnover at the end of its financial year which did not coincide with the end of the year of assessment. The judgment passed by Corbett JA was similar to the judgment that was passed in the *Nasionale Pers Bpk* case. The turnover rent could only be determined at the financial year end.

³ *Nasionale Pers Bpk v KBI* 1986 (3) SA 549 (A), 48 SATC 55

⁴ *Edgars Stores Ltd v CIR* 1988 (3) SA 876 (A), 50 SATC 81

⁵ *Golden Dumps (Pty) Ltd, CIR v*, 1993 (4) SA 110 (A), 55 SATC 198

⁶ *Ackermans Limited v CSARS* 2011 (1) SA 1 (SCA), 73 SATC 1

⁷ *ITC 1801* 68 SATC 57

Therefore, if the turnover rent was higher than the basic rent, *Edgars Stores* would be unconditionally obliged to pay the difference only at the financial year end which fell outside the year of assessment in question. The same concept was discussed in the *Golden Dumps* case and McCreath J came to the same conclusion.

However, in all these mentioned cases, the term 'expenditure' was never defined and the word is not defined in the Act and yet it is a very critical term in determining deductibility. If a taxpayer does not incur any 'expenditure', the deduction will not be permissible. The *Labat* case is the only case that deals with the meaning of 'expenditure'. This research will analyse this judgment passed by the Supreme Court of Appeal (SCA) in order to determine the meaning of 'expenditure' when applied to share – based payments as was the case in *Labat*. This will assist in answering the research question of this paper: was the SCA correct in its decision in *Labat*?

This objective will be reached by analysing the judgment of the *Labat* case and by looking at the relevant provisions of the Act. A comparison with other similar cases will also be done and articles from various authors will also be considered.

Chapter 2

Description of the case

Facts- *CSARS v Labat Africa Limited*

Labat Africa Limited, under its former name of Acrem Holdings Limited, acquired the entire business operations of Labat-Anderson (South Africa) (Pty)Ltd under a business combination with a written agreement dated 15 February 1999. Labat-Anderson's business operations were defined to include all its tangible and intangible assets. The intangible assets included the trademark in particular. Labat Africa acquired the business for a consideration of R120million, which was to be paid by the issue of 133333333 Acrem shares to Labat-Anderson at an issue price of 90cents per share. This purchase price, according to the agreement, was to be apportioned according to the values of the net tangible assets as they were reflected in the accounts. An independent and suitably qualified valuator was to evaluate the trademark and the value was to be determined by that valuator. The balance of the consideration was to be apportioned to Goodwill.

The taxpayer issued the shares and transferred them in terms of the agreement. The trademark, which was valued by the valuator, was valued at R44462000 and the allowance claimed under section 11(gA) was based on this valuation. Section 11(gA), as it read during the 2000 year of assessment when the allowance was claimed, provided for:

“An allowance in respect of any expenditure (other than expenditure which has qualified in whole or part for deduction or allowance under any of the other provisions of this section or the corresponding provisions of any previous Income Tax Act) actually incurred by the taxpayer –

(iii) In acquiring by assignment from any other person any such patent, design, trademark or copyright or in acquiring any other property of a similar nature or any knowledge connected to the use of such patent, design, trade mark, copyright or such property or the right to have such knowledge imparted, if such invention, patent, design, trade mark, copyright, other property or knowledge, as the case may be, is used by the taxpayer in the production of income: Provided that –

(aa) where such expenditure exceeds R3 000, and was incurred –

(A) Before 29 October 1999, the allowance shall not exceed for any one year such portion of the amount of the expenditure as is equal to such amount divided by the number of years, which in the opinion of the Commissioner, represents the probable duration of use of the invention, patent, design, trade mark, copyright, other property or knowledge, or four per cent of the said amount, whichever is the greater.”

The Commissioner for South African Revenue Services (SARS) disallowed this deduction on the grounds that there had been no ‘expenditure actually incurred’ when the taxpayer issued its shares as payment for the trademark, but the taxpayer argued otherwise. Therefore, the dispute lay in the definition of ‘expenditure actually incurred’.

Judgment

The taxpayer appealed to the Income Tax Special Court under *ITC 1801* in which the Tax Court upheld the taxpayer’s appeal. The following reasons were given by the Income Tax Special Court for coming to its conclusion:

Firstly, the expression ‘expenditure actually incurred’ meant 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. This decision relied on *Edgars Stores Ltd v Commissioner of Inland Revenue (Edgars Stores)*. In *Edgars Stores*, Corbett JA held that it was clear from the *Nasionale Pers* case that only expenditure (otherwise qualifying for deduction) in respect for which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of section 11(a) from income returned for that year.

Secondly, the Tax Court also referred to some English judgments that dealt with the effect of a transaction in terms of which a company acquires an asset in consideration of the issuance of fully paid shares. The first judgment relied on was *Osborne v Steel Barrel Co Ltd (Osborne)*⁸, the court, in this case, decided that the issue of shares for the acquisition of assets amounted to “consideration” given by the company. The court also decided on what principle the value of the acquired assets had to be ascertained at, but this was not part of the issue at hand. The other cases were *Craddock v Zevo Financing Co Ltd (Craddock)*⁹ and *Stanton (Inspector of Taxes) v Drayton Commercial Investment Co Ltd (Stanton)*¹⁰. In the *Craddock* case, the court proposed that a company can issue its own shares ‘as consideration for acquisition of property’ and secondly, that the value of consideration given in the form of fully paid shares allotted by a company is not the value of the shares of the shares allotted but is, in the case of an honest and straight forward transaction, the price on which the parties involved in the transaction agreed on. The High Court dismissed the Commissioner’s appeal because it was in agreement with the ITC’s decision.

However, SCA was not satisfied with the ITC’s decision on the grounds that the decision did not deal with the meaning of expenditure and yet that was the reason why the taxpayer and the Commissioner were in dispute. Harms AP, in paragraph 8, said,

⁸ *Osborne v Steel Barrel Co Ltd* 1942 1 A11 ER 634 (CA)

⁹ *Craddock v Zevo Financing Co Ltd* 1944 1 A11 ER 566 (CA)

¹⁰ *Stanton (Inspector of Taxes) v Drayton Commercial Investments Co Limited* 1982 1 A11 ER 121 (CA)

“the terms ‘obligation’ or ‘liability’ and ‘expenditure’ are not synonymous as it is apparent from the judgment of *Caltex Oil (SA) Limited v Secretary for Inland Revenue* by Botha JA in the statement: ‘any expenditure actually incurred’ means ‘all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during the year or not¹¹.”

Harms AP then went on to say that the liability or obligation must be discharged by means of expenditure and timing was not the question. In paragraph 12, the full court held that the term ‘expenditure’ as defined in the English dictionary meant an amount of money spent and in the context of the Act, expenditure would also include disbursement of other assets with a monetary value. The court suggested that the taxpayer had to be poorer at the end of the day because the value of the counter-performance might add more value or might be the same value as the amount expended. This has been described as the “impoverishment test”. Harms AP took the liberty of using Goldbatt J’s judgment in *ITC 1783 (66)*¹² which said an allotment or issue of shares does not in any way reduce the assets of the company although it might reduce the value of the shares held by shareholders, therefore it cannot qualify as an expenditure. The full court also decided that the fact the parties had constructed their agreement differently and tax efficiently was beside the point.

The Commissioner’s appeal was upheld with costs.

¹¹ *Caltex Oil (SA) Ltd v SIR* 1975 (1) SA 665 (A), 37 SATC 1

¹² *ITC 1783 66 SATC 373*, the other case that deals with share based payments

CHAPTER 3

CASE ANALYSIS

Firstly, I will look at the meaning of expenditure in ‘expenditure actually incurred’ with respect to the judgment passed on by the SCA. The problem with share based payments lies in the definition of expenditure because this determines whether share based payments for services rendered will qualify as ‘expenditure’ as defined by the SCA. But before I do that, I would like to first discuss what shares are.

Jansen Van Rensburg does not analyse the *Labat* case per se but his journal article is about the meaning of expenditure regarding share based payments which is directly linked to the judgment of the *Labat* case.¹³

Jansen van Rensburg discusses the legal nature of shares before he considers whether the shares should be considered as expenditure, which, in my view, is a good approach because it helps understand exactly what share based payments are since that is where the bulk of the misunderstanding lies. Jansen Van Rensburg describes shares as a complex of personal rights which are granted to a subscriber but he says that these rights do not include a right of ownership in the assets of the company and the issuing of these shares does not constitute the transfer of a company’s property.¹⁴ From my own understanding, it is usually a right to ownership of the company which results in a right in the distribution of the company’s profits depending on the financial performance and financial position of the company and the class of shares that the shareholder holds, such ownership does not entail that a shareholder owns the underlying assets and liabilities of a company unless the shareholder owns enough voting

¹³ EC Jansen van Rensburg ‘Some thoughts on the meaning of “expenditure” in the Income Tax Act’ TSAR 2013 pg60

¹⁴ EC Jansen van Rensburg ‘Some thoughts on the meaning of “expenditure” in the Income Tax Act’ TSAR 2013 pg60

rights to control the company. Therefore when a company issues shares as payment for services rendered or acquiring assets, it is only giving away a right to a distribution in profits thus none of the company's assets is given or diminished by such a transaction.

Jansen van Rensburg makes a reference to *Lace Proprietary Mines Ltd v Commissioner for Inland Revenue*¹⁵ to show that it may be difficult to distinguish between instances where a company has agreed to pay a monetary amount and those where it has agreed to issue shares, in return for the transfer of assets.¹⁶ Usually when a company issues shares, it gets money from that share issue, however in situations where a company issues shares in return for the transfer of assets or as payment for services rendered, it uses the money received from the allotment from the transferee of the asset as payment for the asset or for the services so received, therefore the situation results in a set-off because money received by the issuer from the transferee goes back to the transferee as payment for asset or services rendered. The confusion that Jansen van Rensburg refers to is the confusion that is caused when a company decides to eliminate the mid process of receiving money for shares received and paying for the asset from the same person that the shares are issued to, and when a company is actually required to pay an amount in cash for the asset acquired.

In *Lace Proprietary Mines Ltd v Commissioner for Inland Revenue*, the tax court had to decide what amount was to be included for the disposal of certain mineral rights if they were considered as not of a capital nature. The agreement between Lace Proprietary Mines and the purchaser for the sale of the mineral rights stated the following: "250000 to be paid and satisfied by the allotment and issue to the seller of 1000000 shares of 5s each in the capital of the purchaser credited as fully paid". The court held that the consideration was 1000000 shares because no cash could be demanded by Lace Proprietary Mines and that the purchaser

¹⁵ *Lace proprietary Mines Ltd v CIR* 1938 AD 267, 9 SATC 349

¹⁶ EC Jansen van Rensburg 'Some thoughts on the meaning of "expenditure" in the Income Tax Act' TSAR 2013 pg61

was entitled to deliver those shares as consideration paid. Therefore Lacey Mines Proprietary was meant to receive a consideration in kind, not in cash. The *Labat* case is much like that *Lacey Proprietary Mines* case because the consideration was also to be satisfied by the issue of shares, the consideration of R120million was to be paid by an issue of 133333333 shares at an issue price of 90cents per share. The seller, according to the agreement, was to receive those shares instead of cash. Therefore, given the facts in the *Labat* case, it is safe to say that *Labat* did not agree to pay a monetary amount for the acquisition of the trade mark. This, however, does not give us the answer to the question whether the taxpayer ‘expended’ any amount in terms of the definition in paragraph 8 and paragraph 12 of the *Labat* case. It only clears the confusion between the issue of shares as payment and actual payment.

I will now consider the arguments raised in favour of and against the *Labat* decision before presenting my own view on the case

3.1 Arguments in favour of the *Labat* decision

3.1.1 ‘Expenditure’ and ‘actually incurred’ are not discrete requirements

Chris Cilliers¹⁷ argues that the reasoning by Harms AP was not flawed. According to Cilliers, Harms AP did not really put the cart before the horse, as was mentioned in the editorial note to the *Labat* case in *The Taxpayer*, but the horse was simply ignored altogether thus Harms AP looked at the cart only. Cilliers suggests that the solution lies in bearing in mind that one should not interpret the word ‘expenditure’ and the phrase ‘actually incurred’ as discrete requirements that have nothing to do with each other. Rather, the phrase ‘expenditure actually incurred’ should be interpreted as a whole, even though some particular cases can depend on

¹⁷ Chris Cilliers ‘The *Labat* decision and the interaction between “expenditure” and the “actually incurred” requirement’ 2011 *The Taxpayer* Volume 60 No 12

a particular requirement of the general deductions formula.¹⁸ This is the situation in the *Labat* case; the problem and the solution are based around the meaning of ‘expenditure’, rather than the ‘actually incurred’ part. Cilliers also says that the criticism expressed in relation to paragraph 8 of the *Labat* case falls away once it is understood that the words ‘actually incurred’ may also operate to lessen or diminish what would otherwise have been expected of a taxpayer seeking to argue that section 11(a) applies in a given situation. He further says that the role played by the word ‘expenditure’ is merely to emphasise that an unconditional obligation on its own is not enough. The subject matter or object of the obligation must correspond to something that would constitute ‘expenditure’ in the sense envisaged in paragraph 12 of *Labat*, in other words, it must involve the diminution or movement of the taxpayers’ assets. He says that this question is capable of being answered before the relevant obligation is discharged. From my understanding of this analysis, Cilliers agrees with Harms AP that even though *Labat* had an unconditional obligation to issue shares as payment, one need in a certain sense not have ‘expenditure’ before there can be said to be ‘expenditure actually incurred’ – to the extent that ‘actually incurred’ means that there need not yet be expenditure.

Cilliers categorises the different kinds of permutations and combinations that can be raised with regards to the general deduction requirements. In category A, if a taxpayer has no unconditional obligation or an object that would constitute ‘expenditure’ in terms of paragraphs 8 and 12 of the *Labat* case, that taxpayer will not qualify for a section 11(a) deduction. In category B, if a taxpayer does not have an unconditional obligation but has ‘expenditure’ in terms of paragraph 8 and 12 of the *Labat* case, that taxpayer will also not qualify for a section 11(a) deduction unless the obligation becomes unconditional. In category C, if a taxpayer has an unconditional obligation but does not have ‘expenditure’ in

¹⁸ Chris Cilliers “The *Labat* Decision and the interaction between ‘expenditure’ and the ‘actually incurred’ requirement” 2011 The Taxpayer Volume 60 No 12, page 226

terms of paragraph 8 and 12 of the *Labat* case, that taxpayer will not qualify for a section 11(a) deduction. Category C is where the *Labat* case falls in to because *Labat* was unconditionally obliged to give away something that did not constitute expenditure according to Harms AP because there was no diminution of assets that was to be anticipated. Cilliers says that the question of whether such diminution of assets is anticipated can be answered before the obligation is discharged.

3.2 ARGUMENTS CRITICISING THE *LABAT* DECISION

3.2.1 CONTRADICTS ESTABLISHED PRECEDENT

With regards to the decision passed by the SCA that the liability or obligation must be discharged by means of an expenditure, in SP van Zyl's¹⁹ opinion, the reasoning by the SCA confuses expenditure with the discharge of an obligation or actual payment of the obligation. It is important to point out that section 11(a) does not require that expenditure must be discharged for an 'expenditure actually incurred' to qualify as a deduction and neither does section 11(gA). SP van Zyl further says that the SCA's judgment is in contradiction to the judgments in *Nasionale Pers Bpk v KBI (1986)*; *Caltex Oil v SIR* and the judgment by Corbett JA in *Edgars Stores v SIR*, where it was confirmed that an obligation need not be discharged for the 'expenditure' to have been incurred. These were some of the cases that were used by the Income Tax Court in reaching its conclusion. These cases all came to the same conclusion that the phrase 'expenditure actually incurred' meant that there had to be an unconditional liability which fell in that specific year of assessment and that the expenditure did not need to be discharged for such 'expenditure' to be deductible under section 11(a) read with section 23(g). Therefore it has been proven by case law that no discharge of expenditure is required for something to qualify as 'expenditure actually incurred'. In SP van Zyl's view, the court

¹⁹ SP van Zyl 'The meaning of "expenditure" for purposes of section 11(a) and g(A) of the Income Tax Act 58 of 1962' 2012 Obiter

confused the meaning of expenditure by interpreting it to mean actual payment whilst trying to distinguish ‘expenditure’ and ‘actually incurred’ which results in two meanings of the same phrase that can contradict each other instead of interpreting the phrase as a whole. The first meaning being - ‘actually incurred’ means that an unconditional obligation must exist and that actual payment is not relevant for an expense to have been incurred, the other meaning being – ‘expenditure’ means the actual discharge (payment) of an obligation. SP van Zyl calls this an untenable situation.

In an editorial note, the statement by Harms AP from paragraph 8 of the *Labat* case judgment which said the following; “In other words, the liability or obligation must be discharged by means of expenditure- timing is not the question” was criticised. It was said that Harms AP made a mistake by saying that statement because expenditure must first exist before it can be ‘actually incurred’.²⁰ ‘Expenditure actually incurred’ refers to the coming into existence of an absolute and unconditional liability, usually to pay or to perform a service but in the *Labat* case the absolute and unconditional liability was to give fully credited shares to the other party. Harms AP seemed to have ‘put the cart before the horse’ because expenditure is not the thing that discharges a liability or obligation, but it gives rise to a liability or obligation. Payment for the expenditure, or rendering a service to the other party, is what discharges the liability or the obligation owing to the other party. *Labat* discharged its liability by the payment of shares.

SP van Zyl lays down the following illustration in his article to illustrate the confusion caused by the SCA. This SCA judgment is not to be ignored as it deals with an important principle that everyone has ignored in the past years, which is to consider whether there was any ‘expenditure’ before we consider the question whether it was actually incurred. The illustration is as follows: “where X incurred an unconditional liability in the 2009 year of

²⁰ 2011 The Taxpayer Volume 60 No 9, page 169

assessment but pays the liability in the 2010 year of assessment, the amount is not deductible in 2010, because it was not actually incurred, although expended. The amount will not be deductible in 2009, because it was not expended, although it was actually incurred.”²¹ So when will this expenditure be accepted as a deduction if we consider both definitions?

Trevor Emslie²² answers this question in a straight forward way when he sets out what he feels to be the correct test for the word ‘expenditure’. This test is based on the *Caltex* case judgment and is as follows:

“ Firstly, 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. Secondly, such expenditure is ‘actually incurred’ in the year in which a taxpayer’s liability in terms of such obligation becomes absolute and unconditional. Thirdly, such liability is discharged, not by the expenditure, but by the payment or disbursement of other assets with a monetary value which extinguishes that liability.”²³

R de Swardt²⁴ argues that in order for a share based payment made for services rendered to qualify as an ‘expense’ that is ‘actually incurred’, the taxpayer should incur an unconditional liability with regards to the expense, with reference to an argument by Burt²⁵. Burt’s argument is based on the *Caltex Oil* judgment, precisely the phrase ‘expenditure would also be actually if an unconditional legal obligation has been incurred in terms of which some performance is due, provided that the performance due has a monetary value. Burt argues that

²¹ SP van Zyl ‘ The meaning of “expenditure” for purposes of section 11(a) and g(A) of the Income Tax Act 58 of 1962’ 2012 Obiter, page 188

²² Trevor Emslie SC ‘Expenditure actually incurred’ 2011 The Taxpayer Volume 60 No 10 and 11. The mentioned test is set out in his article “Expenditure Actually Incurred” which is found in The Taxpayer 183.

²³ Emslie The Taxpayer Volume 60 No 10 and 11, page 186

²⁴ R de Swardt ‘Do share-based payments made for the procurement of services qualify as expenditure actually incurred’ 2008 De Jure Volume 3, Jaargang 41

²⁵ Burt “Issuing shares as consideration” 2004 Tax Planning 133

“the incurral of the legal obligation as a fact cannot be affected by the means by which that obligation is discharged. There is nothing in the *Caltex Oil* judgment that suggests that expenditure will be regarded as having been incurred only if the discharge of the legal obligation results in the diminution of the assets of the person who incurred that legal obligation.”²⁶ In other words, Burt proposes that a taxpayer who has rendered a service with a monetary value has ‘actually incurred’ an expense that is to be measured at the market value.

In the judgment, the SCA held that the term ‘expenditure’ was not defined in the Act. It was an ordinary English word and, unless the context indicated otherwise, its ordinary meaning had to be attributed to it. The ordinary meaning of ‘expenditure’ refers to the action of spending funds, disbursement or consumption, and hence the amount of money spent. In the context of the Act, ‘expenditure’ would also include the disbursement of other assets with a monetary value. SP van Zyl points out that the SCA did not consider the meaning of the term ‘consideration’. The Income Tax Court applied the United Kingdom judgment in *Osborne v Steel Barrel Co Ltd*. In this judgment, the court ruled that the issue of shares by a company amounted to consideration paid. However, Harms AP ruled that this did not bear any relation to whether the issuing of shares equal expenditure. All the English cases that were used by the tax court were considered irrelevant in determining what expenditure meant by Harms AP.

Consideration is defined in the legal dictionary as “[s]omething of value given by both parties to a contract that induces them to enter into the agreement to exchange mutual performances”.²⁷ This definition is something that should have been considered by the SCA

²⁶ Burt 2004 Tax Planning, R de Swardt ‘Do share-based payments made for the procurement of services qualify as expenditure actually incurred’ 2008 De Jure Volume 3, Jaargang 41, page 482

²⁷ Legal dictionary online <http://legal-dictionary.thefreedictionary.com/consideration>

because it encompasses more than what the definition of expenditure encompasses. The definition of expenditure relates to spending of cash only but the definition of consideration encompasses anything with a value on it. The shares issued by *Labat* as payment for the trademark had a value on the market, this was worth to put in to consideration, and yet the SCA said this did not bear any relation to the term expenditure. SP van Zyl puts this point across in a different way in his article. He says,

“Where expenditure relates to the spending of funds or money, “consideration” has a wider application to include the exchange of anything for something else. Although sections 11(a) and 11(gA) do not specifically require that the expenditure must have been incurred in cash, I doubt that the legislator intended to limit the deduction or allowance to cash or funds. Harms AP confirmed this view (par [12]).”²⁸

The problem that was found in the *Labat* case was that there was no contractual obligation by the taxpayer company to spend its own money or disburse any of its assets with a monetary value, and hence there was no ‘expenditure’. In paragraph 14 of the judgment, Harms AP says the following:²⁹

“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.”

This follows a point in paragraph 12 which says that for expenditure requires a diminution or a movement of the assets of the person who expends. The SCA used Goldblatt’s judgment

²⁸ SP van Zyl ‘The meaning of “expenditure” for purposes of section 11(a) and g(A) of the Income Tax Act 58 of 1962’ *Obiter* 2012, p188

²⁹ *Labat Africa Limited, CSARS v, 74 SATC 1 (SCA), paragraph 14*

from *ITC 1783* which was not backed up with any authority; the judgment was based on a textbook passage from *Silke on South African Income Tax*³⁰. This judgment did not make any reference to the Companies Act³¹, as mentioned by the late author David Meyerowitz³² in an issue of the Taxpayer. The Companies Act requires that there should be quid pro quo for the issue of shares; Judge Goldblatt clearly ignored this provision in his judgment as the asset received was the quid pro quo for the shares.³³ However, this judgment was correct in defining the term ‘expenditure’. In SP van Zyl’s point, the court was correct in pointing out that some sort of diminution is required for expenditure to have been incurred. The conceptual framework of accounting even requires the same thing i.e in accounting terms; expenses are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets.³⁴ Therefore the court was correct in this respect. However, the tax court did not apply the “impoverishment test” in its judgment. SP van Zyl points out that in applying the impoverishment test, a person should be very careful not to confuse ‘expenditure’ with actual payment or partings with assets because a person does not really need to actually pay someone in cash someone for a service acquired or reduce their already existing asset base.

SP van Zyl gives the following example to express the point about the impoverishment test and its difference to actual payment or parting with assets in the following way: “X, a physiotherapist, in exchange for services rendered by Y (an electrician), performs physiotherapy on Y in full and final payment of the obligation.”³⁵ As we can see from this

³⁰ *Silke on South African Income Tax*, the Eleventh Memorial Edition by M. L. Stein and C. Divaris (1991), paragraph 7.4

³¹ Companies Act 61 of 1973 applied at the time the time the article was published

³² David Meyerowitz ‘Paying for goods and services by issuing shares’ 2004 *The Taxpayer* 86

³³ David Meyerowitz ‘Paying for goods and services by issuing shares’ 2004 *The Taxpayer* 86

³⁴ A guide through IFRS Part A, The Conceptual Framework and requirements, July 2011, Conceptual Framework A40

³⁵ SP van Zyl ‘The meaning of “expenditure” for purposes of section 11(a) and g(A) of the Income Tax Act 58 of 1962’ *Obiter* 2012, p188

illustration, X did not pay any money for services received from Y and he did not part with any assets that he already owns but what he lost is a right to receive a certain amount from another patient that he was going to charge for the same physiotherapy that he gave to X as payment for services rendered. SP van Zyl says if Harms AP's interpretation of 'expenditure' is applied in this example, the expense was actually incurred when the electrician rendered the services and expended when the electrician accepted physiotherapy as *datio in solutum debiti*.³⁶ Therefore, in this regard, the taxpayer is impoverished. The above example leads us to the second argument that is raised with regards to share based payments as 'expenditure', as mentioned by Jansen Van Rensburg³⁷.

3.2.2 THE RIGHTS FORGONE ARGUMENT

This argument is the argument that:

“Even if it is accepted that 'expenditure' requires a diminution in the taxpayer's assets, it can be said that 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.”³⁸

This is the argument that was used in one of the foreign cases that was used by the Income Tax Special Court in reaching its conclusion. The Income Tax Special Court used three cases from the United Kingdom which were based on share based payments for asset acquisition. However, these cases were criticized by Harms AP when he said he did not understand how they helped in defining expenditure. These cases are: *Osborne v Steel Barrel*

³⁶ SP van Zyl 'The meaning of "expenditure" for purposes of section 11(a) and g(A) of the Income Tax Act 58 of 1962' *Obiter* 2012, p190

³⁷ EC Jansen van Rensburg 'Some thoughts on the meaning of "expenditure" in the Income Tax Act' TSAR 2013 pg64

³⁸ EC Jansen van Rensburg 'Some thoughts on the meaning of "expenditure" in the Income Tax Act' TSAR 2013 pg64

*Co Limited*³⁹, *Craddock v Zevo Finance Co Limited*⁴⁰ and *Stanton (Inspector of Taxes) v Drayton Commercial Investments Co Limited*⁴¹. The *Osborne* case is the case where the right forgone theory is explained, the other two cases deal with the measurement of this right forgone but measurement or valuation was never an issue in the *Labat* case. Therefore I shall only look at the *Osborne* case in more detail.

The *Osborne* case was a case about the acquisition of trading stock with a share based payment. In the *Osborne* case, the question that was raised was whether an amount could be included in the opening balance of the acquired trading stock, which is what brought Lord Greene MR to explain the concept of the right forgone. He explained it as follows:⁴²

“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 allotted 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.”

³⁹ 1942 1 A11 ER 634 (CA)

⁴⁰ 1944 1 A11 ER 566 (CA)

⁴¹ 1982 1 A11 ER 121 (CA)

⁴² Craddock judgment, EC Jansen van Rensburg ‘Some thoughts on the meaning of “expenditure” in the Income Tax Act’ TSAR 2013 pg65

If we apply the ‘impoverishment test’ to the concept of the right forgone, the shares issued for payment will definitely qualify as expenditure according to Harms AP’s requirements for ‘expenditure’, but firstly we need to ascertain if this right is really an asset of the taxpayer. Following from the Lord Greene’s judgment, in the statement, “. 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”, it is clear that the company that issues the shares becomes entitled to payment only when the public subscribes to the share issue, before that there is no right to such because there is no contractual rights that exist on shares. Therefore this right only arises when the shares are subscribed for; hence a company that credits shares as fully paid for does lose on its right to receive cash from that allotment. Rights are assets that an individual expects future economic benefits from therefore by forgoing that right, an individual loses on future economic benefits that were supposed to be received from the individual’s ability to control that right. Because a right is lost, the individual’s assets are therefore diminished. De Swardt also argues that the forfeiture of an expectation could perhaps be classified as a forfeiture of a spes but this kind of forfeiture is not recognised as an enforceable right for it is only the loss of hope of acquiring something.⁴³ De Swardt further 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.⁴⁴

⁴³ R de Swardt ‘Do share based payments made for the procurement of services qualify as expenditure actually incurred’ 2008 De Jure Volume 3, p484

⁴⁴ R de Swardt ‘Do share based payments made for the procurement of services qualify as expenditure actually incurred’ 2008 De Jure Volume 3, p484

This argument takes the same approach that was used to come to the conclusion of *CSARS v Brummeria Renaissance (Pty) Ltd (2007) (Brummeria)*⁴⁵. The judgment to this case raised a lot of questions. The facts of this case are as follows: Brummeria Renaissance obtained interest free loans to finance the construction of units in retirement villages as a quid pro quo for granting the lenders life occupation rights to the units. Brummeria Renaissance had contended that an amount which has accrued to a taxpayer otherwise than in cash only falls within the definition of 'gross income' if it capable of being turned into money. The Commissioner included the taxpayers' gross income amounts representing the value of the rights to use the loans interest free, against which the inclusion the taxpayer objected and appealed successfully to the Tax Court. The Commissioner was not happy with the Tax Court's decision therefore he appealed to the Supreme Court of Appeal. Cloete JA held that the making of an interest free loan constituted a continuing donation to the borrower which conferred a benefit upon such borrower, and it could hardly be doubted that, in the modern commercial world, the right to retain and use loan capital for a period of time, interest free, was a valuable right. In this judgment, the taxpayer did not receive any cash or kind but the SCA held that he had a specific right to the interest free loans and that right could be valued. I do understand that the requirements for 'gross income' and the requirements for something to qualify under the 'general deductions formula' are different but in this respect, *Brummeria* had an amount added to its 'gross income' which it was never going to receive.

Marias⁴⁶ also argues that if the facts of *Labat* are tweaked and *Labat* first issued the shares before receiving the trademark, the resultant situation will be that the taxpayer will be left with a right to claim the asset which will be lost when the taxpayer receives the asset

⁴⁵ *Brummeria Renaissance (Pty) Ltd, CSARS v, 2007 (6) SA 601 (SCA), 69 SATC 205*

⁴⁶ Albertus Marias 'The (in)equity of *Labat*', 2013 *The Taxpayer* Volume 62 No 1

itself.⁴⁷ Therefore *Labat* would have met the requirements if the movement in the assets was the test to be applied.

3.2.3 CREATES ANOMALIES

It was stated in paragraph 17 of the *Labat* decision that anomalies would be created by such a judgment. However, there are far more anomalies that are less complicated than the ones that were mentioned in the judgment.

Harms AP submitted in the judgment that the words ‘obligation’ and ‘expenditure’ are not synonymous, however Marias argues that ‘obligation’ will always rise from ‘expenditure’ because an unconditional liability cannot be present without an expenditure having been incurred in the first place.

Although accounting and tax should not be mixed, applying accounting principles for the *Labat* decision cannot be entirely thrown out of the window. Marias applies the ‘accounting equation’ to the obligation to issue shares.⁴⁸ The accounting equation is as follows: Assets = Liabilities + Equity. Harms AP admitted that there was an obligation at hand, therefore liabilities increased and an increase in liabilities should lead to an increase in assets (assets are considered as glorified expenses by accountants) or a decrease in equity, a decrease in equity which is caused by an increase in expense or loss. The journal entry that follows the transaction would be a credit to the share capital account and a debit to an asset or expense account. This principle should not be ignored because the principle follows that no obligation can arise without a corresponding expense. The SCA acknowledged the existence of an obligation in the *Labat* decision, therefore, using the above principles, the existence of ‘expenditure’ was also acknowledged.

⁴⁷ Albertus Marias ‘The (in)equity of Labat’, 2013 The Taxpayer Volume 62 No 1, page 7

⁴⁸ Albertus Marias ‘The (in)equity of Labat’, 2013 The Taxpayer Volume 62 No 1, p 6

The recently published Binding Private Ruling 124 deals with loan repayments by way of share issue⁴⁹. It is confirmed that where a loan is repaid from the proceeds of a share issue carried out right before the loan repayment, the subscription price paid for the shares issued and used to repay the loan would be regarded as 'expenditure'. This is almost the same situation as the *Labat* case but the mid process is eliminated in the *Labat* situation. The question that arises from this Binding Private Ruling 124 is if a share issue to a creditor for the repayment of a loan will also qualify as expenditure? Marias says that it submitted that this would fly in the face of the 'substance over form' doctrine.

Another anomaly that *Labat* raised was the issue of capital gains tax, but this anomaly was rejected because capital gains tax was only introduced after the tax year under consideration.

3.3 MY VIEWPOINT

I do agree with SP van Zyl's view about the confusion caused by the SCA with regards to the statement that 'liability or obligation must be discharged by means of an "expenditure"'. In my opinion an obligation or liability is discharged by payment and an unconditional obligation arises when expenditure is actually incurred, therefore I agree with the judgment in the *Caltex* case that was applied by the tax court. The pattern should be as follows: 'Expenditure' must be incurred first, if a taxpayer does not pay for the expenditure instantaneously then the taxpayer has an unconditional obligation to pay for that expenditure in the future, this obligation should result in a future outflow of the resources of the company. The last phase is the payment that discharges the obligation from the taxpayer's hands. This makes sense because the term obligation, as defined in the English dictionary, means "the

⁴⁹ Albertus Marias 'The (in)equity of *Labat*', 2013 *The Taxpayer* Volume 62 No, p 6

state of being forced or compelled to do or pay something”. One can only be compelled or forced to pay something when they have already entered in a transaction that has such an effect, which is the expense. However the SCA got the pattern the other way round in the judgment of the *Labat* case. The SCA said that the obligation must be discharged by means of expenditure. Expenditure is a completely different thing from payment but the SCA made it seem like it was the same thing. With all due respect, Harms AP got it all wrong in that judgment. If we look at a different scenario whereby the taxpayer enters into a contract to pay for a service rendered to him by issuing out shares, but the taxpayer somehow breaches that contract and as a result of the breach the taxpayer is required to pay the full amount of the services rendered in the following tax year of assessment. How will this payment be treated if we use the *Labat* judgment because such expenditure will be disallowed in the year that it arose because the contract stated a share based payment? This is the reason why I think that how an obligation or liability is discharged should not matter as long as the taxpayer is compelled to perform. Therefore how an obligation is discharged should not matter, what matters is the incurrance of an expense which leads to an unconditional obligation. This is what determines whether that thing should be deducted under the general deductions formula or other specific deductions, in this case, a deduction allowable under section 11(gA).

I think Chris Cilliers raises a good point in his illustration of category C where an unconditional obligation can exist but the object or subject-matter of obligation does or would not constitute ‘expenditure’ as contemplated in paragraphs (8) and (12) of *Labat*. However, if we take the share issue by *Labat* as payment and use the rights forgone argument, we can see that the shares issued result in an object or subject of obligation that constitutes ‘expenditure’ as contemplated in paragraph (8) and (12). The right to receive cash in order to raise capital for the taxpayer’s patrimony has been forgone therefore the assets of

the taxpayer have diminished. The definition of expenditure as contemplated in the *Labat* judgment requires that there should be the actual spending of money or the actual disbursement of an asset with a monetary value which results in a diminution or movement of the assets of the person who expends. I also do not agree with Cilliers because the actual meaning of expenditure is not, with all due respect, the meaning that was attributed to it in the *Labat* judgment. The meaning attributed to the term best defines payment even though the meaning is taken straight out of the dictionary. Emslie says expenditure is the contractual (or other legal) obligation to spend money or to disburse an asset with a monetary value which will result in a future diminution or movement of assets of the person who expends.⁵⁰ This meaning distinguishes expenditure from payment. Therefore Cilliers argument falls away because 'expenditure' as contemplated in paragraph (8) and (12) is actual payment and also the requirements are of the aforementioned paragraphs are satisfied.

With regards to the right forgone argument, I strongly agree with the argument that a taxpayer loses a right to receive cash when he decides to make a share based payment. In my view, the same can be said when a taxpayer loses the right to get a payment for a service rendered, or in other words, the right to enrich oneself for example when a debtor goes bad; this should be considered as 'expenditure actually incurred' because the taxpayer could have easily gained from that activity or transaction but instead the taxpayer gave that right up. If we consider the example of a debtor not being able to pay for their debts to the taxpayer, the taxpayer had a right to receive the money hence such amount was included in the assets of the business but when the debtor defaults on payment, the taxpayer loses the right and that right becomes an expense. If a taxpayer can have money that will never be received in their 'gross income', giving up something that does not affect the financial performance or

⁵⁰ 2011 The Taxpayer Volume 60 No 10 and 11, p185

financial position of the taxpayer, depending on the situation – in this case, paying for services rendered by issuing shares - should also have an effect because the taxpayer loses out on raising capital from that share issue.

The above example is similar to the recent authority where a taxpayer gave up their rights to receive payment but this was not allowed as a deduction in the *Ackermans* case. Van Rensburg says that there are similarities between arguments raised by the taxpayers in the *Labat* case and the *Ackermans* case which become apparent if one rewords the argument in the *Ackermans* case as follows: “the taxpayer had the ‘right’ to sell its business assets for cash”.⁵¹ The similarity comes when we say that Ackermans gave up its right to receive the cash for its business assets when the purchaser assumed its liabilities in the agreement. The facts of *Ackermans Limited v CSARS (2011)*⁵² are as follows: The taxpayer sold a business to Pep Stores (SA) Limited as a going concern. The purchase price was defined as the amount equal to the sum of R800million and the rand amount of the liabilities which was an amount of R329 4440402. The liabilities included contingent liabilities which were conditional as at the effective date when Pepkor assumed them. The taxpayer sought to deduct the amount of the contingent liabilities in terms of section 11(a) on the basis that it was required to forgo a portion of the purchase price it would otherwise have been entitled to, this amounting to an ‘expenditure actually incurred’ in the form of the contingent liabilities. Cloete JA held that the fact that the taxpayer 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 was reduced by the liabilities. The SCA held that a taxpayer can incur ‘expenditure’ only if it has incurred a ‘liability to pay’.

⁵¹ EC Jansen van Rensburg ‘Some thoughts on the meaning of “expenditure” in the Income Tax Act’ TSAR 2013, page 72

⁵² *Ackermans Limited v CSARS 2011 (1) SA 1 (SCA)*,73 SATC 1

Firstly, contingent liabilities⁵³ are possible obligations or present obligations which do not meet the recognition criteria for liabilities because their existence can only be confirmed at a later stage in the future or it is not certain that an outflow of cash will be required for settlement of such an obligation; therefore the business sold by Ackermans to Pep was not sold at Net present value because contingent liabilities do not affect the financial position of a company. The taxpayer, in support of its claim, argued that ‘expenditure’ includes all ‘actual, quantifiable diminutions or prejudicial effects suffered by the taxpayer’s patrimony’. However, the taxpayer forgot that such expenditure had to meet certain requirements first. From the previous cases mentioned above, a liability gives rise to an unconditional obligation, that condition is not met by contingent liabilities (contingent liabilities are also not considered as liabilities in accounting, they are only disclosed in the notes for the purpose of fair representation to the users of such information). Hence the taxpayer included these contingent liabilities at its detriment because it had no present obligation. Secondly, the taxpayer did incur ‘expenditure’ as defined in paragraph 12 by Harms AP because there was a diminution of the taxpayer’s assets, however, this diminution was one which the taxpayer decided to do on its own, and there was no unconditional obligation for the diminution of the assets. Therefore, in my opinion, yes the taxpayer had a right to receive the amount that was given up for the contingent liabilities and he did meet the ‘expenditure’ requirement in paragraph 12 but the taxpayer did not meet the ‘actually incurred’ requirement of the ‘general deductions formula’. If we use Cilliers’ analysis to the *Ackermans* case, this situation is in Category B where there is no unconditional obligation but there is an object or subject matter of obligation which constitutes ‘expenditure’ as contemplated in paragraph 12 of the *Labat* case. Thus we cannot compare this case to the *Labat* case because *Labat* had an unconditional

⁵³ A Guide through IFRS Part A The conceptual framework and requirements IAS37 par10(a)

liability to issue those shares as payment. The right forgone principle only applies to situations where there an unconditional obligation was present.

These are the anomalies that the taxpayer submitted before the SCA in paragraph 17⁵⁴. The taxpayer's counsel mentioned that it would be incongruous to regard the shares issued by the taxpayer company as being 'consideration' in the hands of the 'purchaser' for the same purpose of selling the trade mark. Harms AP responded to this by saying that "taxable income is not the difference between gross income and expenditure; and gross income is not limited to the converse of expenditures. In my view, this anomaly was not expressed in a way that it should have been properly expressed; the taxpayer should have referred to the inclusion of rights in the gross income as was done in the *Brummeria* case. I do agree with Harms AP when he says that gross income is not limited to the converse of expenditures but the rights argument that was used in the *Brummeria* case could have easily been used to prove a point by the taxpayer's counsel because as we saw earlier, *Brummeria* had to include a right that it had received in its gross income. What if it had lost that right due to some unforeseen circumstance? Would the loss of such a right have resulted in 'expenditure actually incurred'? My opinion is it would have been included because the test of the movement of assets for existence of expenditure would have been satisfied.

Marias points out that the South African Revenue Service Draft Interpretation Note which is dated 16 March 2004 on the issue about share based payments which takes the view that costs funded by a share issue are not 'expenditure' as contemplated in the Act has never been finalised.⁵⁵ It is definitely interesting to note that it has never been finalised. One cannot

⁵⁴ Labat decision paragraph 17

⁵⁵ Albertus Marias 'The (in)equity of Labat', 2013 The Taxpayer Volume 62 No 1, page 8

help but wonder why it has never been finalised. Maybe it is because it remains a controversial issue in the tax community.

CHAPTER 4

SIMILAR CASES

As mentioned earlier, the *Labat* case is the first case to deal with the definition of expenditure, however, since this research is based on the deductibility of share based payments, there are other cases where the same issue was the problem. The cases are looked at briefly below:

ITC 1783

*ITC 1783*⁵⁶ was the other main case that directly dealt with the deductibility of share based payments but the case was only an Income Tax Special Court case, which makes the *Labat* case superior to it.

A company entered into an agreement for the purchase of part of a seller's business. Consideration to be paid for the business, as stated in the agreement, included an amount relating to the license agreement belonging to the seller. The licensing agreement comprised a licensing agreement with an Australian company and this included all intellectual property and know-how relating to the seller's business. The purchaser paid the consideration required by the issue of ordinary shares to the seller at a premium. The Commissioner argued that the taxpayer did not incur any expenditure because the issuing and allotment of shares by a company does not constitute expenditure incurred by a company.

⁵⁶ ITC 1783 (2004) 66 SATC 373

The court's judgment, as held by Goldblatt J, was based on a South African textbook, *Silke on South African Income Tax*⁵⁷. The court held that the taxpayer had not incurred any expenditure according to the findings in the textbook used. The following statement is the statement that determined the judgment for this case:

“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.

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 assets, 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 any of its moneys or assets which, it

⁵⁷ The Eleventh Memorial Edition

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."

Hence the court decided that the taxpayer did not satisfy the court that it had incurred the expenditure as required by the Act.

This is the case that received criticism from the late David Meyerowitz⁵⁸ in an article in *The Taxpayer*. It was truly perplexing that Goldblatt J did not use any authority in reaching his decision considering that the United Kingdom cases that were referred to in *ITC 1801* are fairly old cases that were present at the time that this judgment was passed, even though Harms AP said that they did not assist with dealing with the meaning of 'expenditure'. However, from the textbook passage quoted above, we can see that the author described the situation that I described earlier; the situation when the taxpayer decides to eliminate the mid – process of getting payment from the employee and using that same payment to remunerate the employee.

We can also have a look at a foreign case that was not used by the tax court in the making of its decision but would have been considered as relevant since the tax court did use foreign authority to come to its decision. The case is an Australian case and according to Van Ransberg⁵⁹, the Australian Taxation Office does not regard share – based payments as either an 'outgoing' for purposes of section 8-1 of the Income Tax Assessment Act, 1997, or 'expenditure' for the purposes of section 73B (which is a section that allows for a deduction in respect of research and development) of the Income Tax Assessment Act 1936 – which is considered to be the equivalent of the general deduction formula in the South African Income

⁵⁸ Meyerowitz 'Paying for goods and services by issuing shares' 2004 *The Taxpayer* 86

⁵⁹ EC Jansen van Rensburg 'Some thoughts on the meaning of "expenditure" in the Income Tax Act' 2013 TSAR.1, page 64

Tax Act. In Van Ransberg's view, this is the case that actually considered the meaning of 'expenditure'. This facts and the judgment of the case are below:

Lowry (Inspector of Taxes) v Consolidated African Selection Trust Limited⁶⁰

The taxpayer issued some shares to employees at par value. This value was considerably less than the market value of the shares. The taxpayer claimed the difference between the par value and the market value of the shares as a deduction in its calculation of its corporate income tax liability.

The court held that such difference was not deductible. In the judgment, Viscount Maugham said the following; "Indeed the issue of shares by a trading company is not a trading transaction at all. The corporate entity becomes pro tanto larger; but the receipts of the trade on the one hand and the amount of the costs and expenditure necessary for earning those receipts on the other remain unaltered, and it is the difference between those two sums which is taxable". Viscount Maugham further says that the issue of shares by a company does not affect the profits or gains or losses of the company for the purposes of Income Tax, whether they are issued at par or over. Viscount Caldecote LC asked whether the issue of these shares in the manner adopted involved the taxpayer company in any 'disbursements or expenditure...wholly laid out for the purposes of' its trade if its capital was intact after the issue of the shares. He concluded by saying that the taxpayer's trading receipts were not diminished, nor did he think that it was in the right view of the facts to say that the taxpayer company gave away money's worth to its own pecuniary detriment.

This case is different from the other share based payments cases, which might be the reason why it was not considered by the tax court when the tax court came to its conclusion.

⁶⁰ 1940 AC 648 (n 35)

It was a case that did not deal with share based payments per se; it dealt with the issue of forgoing a premium amount. However, as seen from the above, the judgment was somehow similar to the judgment by Goldblatt J in his decision for ITC 1783.

*ITC 703*⁶¹

In 1950, the Income Tax Court of Natal had to decide if a share based payment was deductible. The share based payment was made for technical services in connection with the erection of a factory and the subsequent supervision of its production. The issue that the court had to decide on was whether such payment was deductible but the only question that was brought before the court was whether the expenditure was of a capital nature or of a revenue nature.

The court viewed that the payment was to cover the costs of the services rendered to the appellant company, both in respect of the erection of the factory building and from then on in respect of the conduct of its business. However, with regards to the payment in respect of the conduct of the appellant company's business, the court held that it was not of a capital nature but the payment in respect of the erection of the factory building was undoubtedly of a capital nature.

*ITC 1822*⁶²

This was another recent case that dealt with share based payments. The Pretoria Tax Court, in 2006, had to decide whether the transfer of a taxpayer's own shares to a supplier of a service constituted payment or not. Bertelsman J followed the judgment in *ITC 1801* by Jootse JA. The decision in *ITC 1801* conflicted with the decision in *ITC 1783* but Bertelsman referred to

⁶¹ *ITC 703*, 17 SATC 208

⁶² *ITC 1822*, 69 SATC 200

the judgment in ITC 1801 as a “comprehensive and most persuasive judgment” because it cited the dictum of Nicholas AJA in *Edgars Stores Ltd v CIR [1988] 50 SATC 81* at 95 that: "Actually incurred does not mean ‘actually paid’, but means all expenditure actually incurred during the year, whether the liability has been discharged during that year or not." The court in *ITC 1783* had not considered precedent from the highest court in the United Kingdom, which had rejected the statement that the issue of shares was not the giving of a consideration for the acquisition of assets.

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CHAPTER 5

CONCLUSION

To determine the tax liability of a taxpayer, the taxpayer should be allowed certain deductions and allowances from his income. Hence the main question to be asked when a company pays for the receipt of services by issuing its own shares is whether or not the company has met the requirements of section 11(a) read with section 23(g), precisely the phrase ‘expenditure actually incurred’ for such payment to be allowed as a deduction against the taxpayer’s income. This is because this issue is not dealt with in the Act; hence the question still arises even though the *Labat* case brought some light to the issue. The issue about shares issued as payment for services rendered is a very tricky situation to deal with because the only clarity in the Act is on share based payments made for the acquisition of assets. Even after the *Labat* judgment, tax professionals are still debating this issue because it was not. In my view, there might have been a wrong choice of words in the judgment. However, one has to rely on the decision of the *Labat* case, as flawed as it is, because it is the only case that deals with such a situation and because it was a SCA decision which must be followed by all the courts below. Taxpayers therefore need to be careful when entering into transactions in which they will be required to issue shares to the other party so that they do not get in predicaments such as the *Labat* case by not eliminating the mid process that is usually eliminated when a taxpayer makes a share based payment. In other words, taxpayers need to pay cash for the service rendered and have the other party pay for the shares issued to it using the cash received for the services rendered.

The argument that a taxpayer company incurs a legal unconditional obligation on conclusion of the contract to make a share based payment which results is considered as ‘expenditure’ in terms of section 11(a) and section 11g(A) thereof is a strong and compelling

which should be taken in to consideration. Once a taxpayer has an unconditional liability, according to case law, that taxpayer has actually incurred expenditure because the incurrence of expenditure is not limited to an outlay of cash as stated by Harms AP in the *Labat* decision. The term ‘expenditure’ was defined as a diminution or a movement of assets of a person who expends the funds, in the findings of *Labat*. The term ‘expenditure’ is not defined in the Income tax Act 58 of 1962.

Another compelling argument is the argument that when a taxpayer agrees to make a share based payment; it forgoes its right to claim cash which results in the taxpayer losing out on an asset and subsequently meeting the requirements for ‘expenditure’ as defined in the *Labat* decision. If the outcomes of the foreign case laws that agree with this argument that a taxpayer loses a right to receive payment when the pay for service with a share based payment are followed, the share based payments for services will be deductible as long as the taxpayer meets all the other requirements for such deduction to be allowable. This argument also meets the definition of ‘expenditure’ as defined by Harms AP and Goldblatt J that ‘expenditure’ entails a disbursement of assets, because when a taxpayer loses a right, an asset is lost since rights are considered as assets.

In my opinion, shares issued for payments do qualify as ‘expenditure actually incurred’ because of the arguments that I have dealt with above. I therefore believe that the *Labat* decision was wrongly decided by the SCA. In my view, to eliminate confusion and disappointment where the court may not allow such deductions, taxpayers should attempt not to skip the mid process of acquiring cash from the seller for the shares and using that money to pay for the services received. It may seem redundant, but it is better to be safe than be in a situation that *Labat* was in.

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