

12 Law

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This paper is divided into six principal chapters. As far as possible each chapter has been made pertinent to a particular topic under discussion.

Chapter Two provides an overview of the machinery provided by Section 311 the Companies Act 61, of 1973, as amended.

Chapter Three focuses on the Primacy of Assessed Loss and the General Principles Regarding Section 20.

Following on discussion on section 20(1)(a)(ii), Chapter Four tackles the vexed problem of Preserving the Assessed Loss, and various innovative schemes available to circumvent the obstacles placed by the applicable provision.

Chapter Five examines income tax pitfalls of Trafficking Assessed Losses of Companies, the mechanics of Section 103(2). And Conshu (Pty) Ltd v CIR (hereafter referred to as “the Conshu case”) is revisited.

The Concluding Chapter sums up all the questions that have greatly exercised the Scheme of Arrangement industry, by examining the position in terms of legal and tax efficacy and to identify Commissioner of Inland Revenue’s attitudes as known in the present time as wells as to give some positive guidance on how matters may possibly be looked at for the foreseeable future until the views of both the Commissioner of Revenue and the Appellate Division are more clearly defined and better known.

CHAPTER 1
THE ASSESSED LOSS THE DRIVING FORCE BEHIND SCHEMES OF
ARRANGEMENTS AND COMPROMISE UNDER SECTION 311 OF THE
COMPANIES ACT

1.1 Purpose and Scope

The desire of virtually all taxpayers today is to find some means of minimizing their taxes. The search for tax shelters by taxpayers is relentless.

Tax considerations are hallmarks of scheme of arrangements and compromise carried out in terms of s311 of the Companies Act. The scheme of arrangements gained popularity during the sanctions era as a tax saving device. Broadly speaking, s311 schemes have been employed as a relatively inexpensive method of acquiring financially distressed company being wound up with one of the most alluring commodities from tax point of view - a large balance of assessed loss to generate tax-sheltered income.

The retention of assessed loss is paramount concern of proposers of s 311 scheme of arrangements and compromise with creditors. It is, therefore, a matter of considerable import that an insolvent company's assessed loss remain largely intact. And when it comes to structuring an arrangement or compromise, the choice of scheme is even more crucial especially if the objective is the set-off of assessed loss against current income.

The assessed loss has been described as the *leit motif* behind the beneficial use of statutory corporate re-organization facilitated by s 311 of the Companies Act.

To the extent that schemes of arrangements and compromise are used to obtain substantial tax savings, the taxpayers make very considerable inroads into the fiscus. As soon as one starts to engage in s311 schemes of arrangements and compromise, one is liable to draw bit of attention to trafficking in assessed losses of companies and to provoke the Commissioner of Inland Revenue into a counter-attack.

The opportunity to get assessed loss set-off against income is governed by two complimentary provisions, namely, sections 20 and 103(2). Section 20(1) results in a forfeiture or sterilization of assessed where there was mercantile abstinence on the part of the company.

While section 20(1)(a)(ii) provides that the balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a concession granted by or compromise made with his creditors whereby his liabilities to them have been extinguished, provided that such liabilities arose in the course of trade.

Further disqualification is provided by s103(2) which is specifically aimed at restricting trafficking in assessed losses of companies. The tax efficacy of s311 schemes can be easily overshadowed by adverse tax treatment under aforementioned provisions.

CHAPTER 2

SCHEMES OF ARRANGEMENTS AND COMPROMISE CARRIED OUT IN TERMS OF SECTION 311 OF THE COMPANIES ACT 61, 1973

2.1 Background

A method of acquiring the shares in a company via what is commonly referred to as a “scheme of arrangement” carried out in terms of s311 of the Companies Act 61,73, as amended is a familiar one. It is a procedure designed to facilitate compromises and arrangement between companies, their members and creditors. Because of its origin, nature and sphere of application, where normal mechanisms are available, the scheme of arrangement is inappropriate.

The *raison e’etre* of s311 machinery has been described in the clearest terms in Australian Company Law ed by Patterson and Edrie:

*“The section is intended to provide machinery (i) for the overcoming the impossibility of obtaining the individual consent of every member of the class intended to be bound thereby; (ii) to prevent in appropriate circumstances a minority of class, members frustrating a beneficial scheme....”*¹

And concisely and felicitously described in Ex parte Lomati Landgoed (Edms) Bpk:

*“The purpose of section 311 of the Companies Act can be concisely put as being an attempted solution of the problem attendant upon obtaining an agreement in the case of a large number of widely distributed people who must be contacted with view to negotiating the same agreement with each one. Section 311 is therefore particularly applicable where it is impossible or difficult to approach everybody individually with a view to submission of the offer.”*²

In a sense, therefore, the machinery is created to bind dissenting recalcitrant minority to the agreement between the company and majority of members or creditors. Consequently a proposer of scheme of arrangement and compromise must surely be acquainted with complex and multifarious procedure prescribed by the Companies Act³.

The scheme of arrangement, generally, comes into play when a company cannot pay its creditors and a compromise is proposed and has to be sanctioned by the Court. Faced with a choice of a reduced pay-out of their claims and attendant costs of liquidation (or even merciless ravages of inflation), creditors of the company will be heavily inclined to the former. An insolvent company’s

accumulated assessed loss is the major impetus and incentive for third parties seeking to initiate section 311 schemes of arrangements and compromises with company, its members and creditors. The Taxpayer sums up the position of a would-be acquirer of a company which enjoys an assessed loss for income tax purpose is as follows: ‘he would wish to effect a compromise or arrangement between the company and its creditors to obtain the protection afforded by section 311 of the Companies Act, yet he would wish to minimise an amount or benefit of any such compromise in order to preserve the company’s assessed loss largely intact.’⁴

An approach that might suggest itself as fruitful for discussing schemes of arrangements and compromise and seeking to explain the development in this area, or their absence is to pay homage to the rather direct mandates of the relevant provision.

2.2 Provisions of Section 311 of the Companies Act

✱ The relevant part section provides as follows:

311(1) *“When any compromise or arrangement is proposed between a company and its creditors or any class of them or between a company and its members or any class of them, the court may, on the application of the company or any creditor or any member of the company being wound or, in the case of a company being wound up, of the liquidator, or if the company is subject to a judicial management order, of the judicial manager, order a meeting of the creditors or class of creditors, or of the members of the company or class of members (as the case may be) to be summoned in such a manner as the court may direct*

(2) *If the compromise or arrangement is agreed to by -*

(a) *a majority in number representing three-fourths in value of the creditors or class of creditors; or*

(b) *a majority representing three-fourths of the votes exercisable by the members or class of members,*

(as the case may be) present and voting either in person or by proxy at the meeting, such compromise or agreement shall, if sanctioned by the court, be binding on all the creditors or class of creditors, or on members or class of members (as the case may be) and also on the company or the liquidator if the company is being wound up or on the judicial manager if the company is subject to a judicial management order.

2.2.1 Meaning of Compromise and Arrangement

The wording of s311 is not quite what one would expect, it does not provide precise definition of the terms “compromise or arrangement”. We have, therefore, to rely on a number of judicial decisions. In Re NFU development Trust Ltd Brightman J gave the following definition:

“The word ‘compromise’ implies some element of accommodation on each side. It is not apt to describe total surrender. A claimant who abandons his claim is not compromising it”

Later decisions have made it clear that a “compromise” (*transactio*) is an agreement to settle right or modify undisputed rights where difficulty exist over their enforcement. Each party must give ground, but there must be a *quid pro quo*, not a gratuitous giving up of rights”.⁵

An arrangement, by contrast, is a much wider concept, although similar to a compromise. An arrangement includes a reorganization of the share capital and persons of the company by the consolidation of shares of different classes or by both these methods. An arrangement implies some element of “*give and take, some compensating advantage to the members or creditors concerned*”⁶

Accordingly there is no arrangement where its is proposed to confiscate rights of members without receiving compensating advantages. Such advantage must relate to some enforceable consideration for those concerned. In other words, the meaning of “rearrangement of rights” as used by the Legislature carries, at its core, survival of rights in different form and certainly not disappearance⁷. Significantly, it is now established that section 311 is to be construed liberally and thus no narrow interpretation should be given to the expressions “compromise or arrangement”⁸.

2.2.2 Meaning of Class of Creditors

Once an applicant decides to propose an arrangement, it obviously becomes vital to determine precisely what class of members or creditors of the company should be made parties to the proposed scheme. The word “class” is not defined, but guidance may be obtained from Sovereign Life Assurance Co v Dodd, where Bowen J indicated that the meaning of class

should be confined to “*those persons whose rights are not dissimilar as to make it impossible for them to consult together with a view to their common interests*”.⁹

The matter about which test to apply when determining what constitutes a “class” has now been rested. Creditors or members belong to the same class when their “rights are not so dissimilar as to make it impossible for them consult with a view to their common interests. It is now accepted that the test of commonality of rights is the proper one.

2.2.3 The importance attached to the role of the company

As we shall presently see, the South African Courts have at various stage sought to elevate the role of the company in the scheme of arrangement process. Only recently has some reconciliation effected. Consequently it has long been a controversial whether an insolvent company should be play an active role in the process leading up to the court sanctioning the scheme. By contrast, the English Court have attached less importance to the role of the company in the scheme of arrangement¹⁰, thus an undertaking to register the transfer of shares is sufficient to comply with the jurisdictional requirements of the English Companies Act.

In order to comply with the jurisdictional requirements of s 311, the arrangement must either be between the company and its members or the company and its creditors. Even if a proposed compromise or arrangement between the company and persons who are not members or creditors of the company may be beneficial both to the company and to its creditors or members, the court has no jurisdiction under s 311 both to order a meeting to consider a compromise or arrangement or sanction it.

In the 1987 case of Ex parte Kaplan & Others NNO: In re Robin Consolidated Industries (Pty) Ltd¹¹ (hereafter referred to as “the Robin case”) Coetzee DJP obstinately refused to backdown, reiterating his view that, a court has no power to order a meeting to consider an arrangement which is not one between the company and its creditors. That did not mean that only these two parties could validly be involved in an arrangement without putting it beyond the pale for that reason. Thus it does not cease to be an arrangement merely because third persons must consent to perform certain duties, administrative or otherwise or are required to make finance or shares or other rights available to the company or members or creditors.

However, once, on proper construction of their contract, the third person is the true party to the arrangement to the exclusion of one of the others, it can no longer be said to be an arrangement between these latter two parties. That would destroy the privity between the company and creditors or members, which is a vital prerequisite for operation of section 311. He added :

*“One has to distinguish carefully between the basic content and the ancillary provisions of a scheme lest there is smuggled in, via the latter, something which is essentially part and parcel of its basic content and asof the arrangement and therefore merely ancillary to it must be exposed. This is where, I believe, the reduction of scheme breaks down”*¹²

There is little doubt that the decision of Coetzee DJP constituted a catastrophe for many so-called standard schemes and practitioners who then had been making an extremely lucrative living from the promotion, circularizing and implementation of many of these schemes. The partial cession scheme received a short shift at the hands of the Cape Court in Ex parte Millman & others NNO: In re Multi-bou (Pty) Ltd and others¹³ (hereafter referred to as “the Multi-bou case”). Berman J having considered the judgment in the Robin case, concluded that the scheme in question, was in truth and in fact nothing but the standard scheme in another form. He added, for sake of clarity, that it was a sham, a disguised or simulated transaction, structured to bear appearance and give the impression of an arrangement between the company and its creditors, when in substance it remained an arrangement between the proposer and the creditors.

By contrast, the Natal Court in Ex parte Strydom NO: Central Plumbing¹⁴ (judgement delivered by Friedman J who had sat with the Cape Court in Multi-bou gave a green light to the standard scheme. The learned judge stressed the fact that because a deemed, as opposed to actual, cession was present, the company was required to recognise a state of affairs which did not in fact exist. By implication the participation of the company is required, to give effect to the deemed cession. It has been correctly pointed out that is an inaccurate interpretation.¹⁵ The section does not deem the dissenting creditors or members to have agreed to anything. It simply renders them bound.

More recently, the Appellate Division¹⁶ has pronounced that, because s311 schemes are very

useful in the business world, the courts ought not to give a narrow construction to the provisions to a compromise or arrangement proposed between the company and its creditors, company's active role to be substantial. Section 311 schemes have served historically important purpose.

2.2.4 Sanctioning the Scheme

In exercising its discretion under s 311 the court is in effect wields the power of "life and death" over a company in relation to which compromise has been proposed¹⁷. The sanctioned scheme binds the company and all the creditors or members, or classes of either of them, the liquidator, if the company is being wound up, the judicial manager, if the company is under judicial management, and even outsiders. The only limitation placed on the scheme are from the general law.

2.3 Miscellaneous Barriers

2.3.1 Subordination of Claims

The essence of subordination agreement is that a creditor usually a substantial one (who is also a major shareholder of the company) agrees not to enforce or accept payment of his claim against the company until the occurrence of a particular event, such as the restoration of the company to solvency, or payment of all other creditors¹⁸. This kind of agreement is often recommended by the insolvent company's auditor who otherwise would be required to report the fact that the company is trading in insolvent circumstances as material irregularity in terms of s20(5) of the Public Accountants and Auditors Act 80 of 1991.

It becomes necessary therefore to assess the interface between subordination of claims and section 20(1)(a)(ii). Where the *quid pro quo* for agreeing to subordinate the ceded claims is interest at a market related rates, even though the company has been given an extra lease through an extension of time within which to satisfy the claims, the liability have not been reduced. This means that all the *essentia* for the application of s20(1)(a)(ii) are not present. In the absence of a *quid pro quo*, however, the court could still rule, consistent with prior precedents, that the company has benefitted as a result of extension of time within which to satisfy the claims, its liability have also been reduced. The rationale for invocation of section

20(1)(a)(ii) is that liabilities have also been reduced in that on subordination the company's liability is not to pay the face value of the ceded claims but the present value of the claims at the uncertain date upon solvency and the claims become enforceable. The potential reach of s20(1)(a)(ii) is still uncertain despite the benefit to the company because the calculation thereof is conspicuously imprecise. Where it was impossible, on what was submitted to the court, to quantify the benefit by reason of conversion of trade shares, section 20(1)(a)(ii) does not apply. This was held by the Special Court in ITC 1613,¹⁹ the primary reason being the absence in monetary terms and without prescribed formula on deeming provisions in the Income Tax Act, it was not possible to ascribe a monetary value to the benefit. Accordingly the company's assessed loss survived revenue attack largely intact.

Recognizing the need for negating potential attack in terms of section 20(1)(a)(ii), Getz and Jooste²⁰ have recently proposed a novel and provocative solution: make the subordinated claims to attract interest at market rates (such interest also be subordinated). The contention that subordination *per se* result in the application of s 20(1)(a)(ii) is supported by the rationale behind the provision. The assessed loss arises as a result of certain expenditure and allowances being deductible for income tax purpose but there being no expenditure and allowances off.²¹

2.3.2 Trading in Insolvent Circumstances its Relevance to Sections 311 and 424 of the Companies Act

One of the most significant barriers to the sanctioning of the scheme relates to the financially distressed company's continued insolvency. In considering the prospects of an insolvent company following a discharge from liquidation, Coetzee DJP expressed a reluctance to sanction compromise and schemes of arrangement that would "send back into business world the same hopelessly insolvent company to trade and incur debts as before"²². Although debt subordination has been widely offered as a corrective to the perceived defects of sending back into commercial world the same hopelessly insolvent company, Coetzee DJP did not regard this as a satisfactory solution and preferred the conversion of the ceded claims into new capital. The Court in Multi-bou²³ opted for the middle course, holding that a meticulously worded subordination could restore a company to solvency. The matter rested for a while, unresolved, and when the Appellate Division²⁴ was afforded the chance of taking sides in or

contributing to the debate, it affirmed the efficacy of subordination agreements, that the 'solvency' of the company could be satisfied by subordination. It is important to note, furthermore, that the court will only in exceptional circumstances sanction a scheme that would permit a company to carry on business where its liability (including future and contingent debts properly valued) substantially exceed its assets.

It remains only to address the question of corporate controllers' liability for reckless trading. One of the most serious consequences of an insolvent company continuing trading pertains to the responsibility of directors²⁵. In terms of s424 personal liability for the debts of a company can be imposed on persons who were knowingly a party to the company or any other person for fraudulent purpose. It should be remembered that even if it is not possible to establish recklessness mens rea it is still sufficient to impose liability. However, the reckless trading section has so far proved to be less effective in curbing corporate delinquents.

In South Africa the position in regard to whether the court ought not to sanction a compromise where probable result will be to allow corporate delinquents to go unpunished can be described as partially settled. Generally speaking, it is, I think correct to say that the Appellate Division has in principle accepted the possibility of wrongdoers escaping liability would not bar the court from ordering the summoning of meetings. In doing so the court will be placed in a better position to determine the issue when asked to consider the scheme, at which stage it will usually determine the effect of the creditors' acceptance of the proposal. The same consideration applies with respect to civil liability of corporate officers.

2.3.3 The Effect of Section 311 Scheme on the Claims of the Revenue

A scheme that constitutes a fraud on the revenue ought not to be approved. Sections 31 and 32 of the Exchequer Act 66 of 1975 provide a mechanism by which a state structure, or official can write off the whole or any portion of a tax claim, and accordingly if an arrangement in terms of s 311(1) contains an offer in respect of such a claim, it can be accepted provided that the requirements of s31 of the Act are complied with. Thus in Namex²⁶, Van Heerden JA held that the commissioner is bound by s311 scheme in respect of his claims for assessed or known tax liability of company, provided the preconditions set out in

the relevant Act are satisfied.

It will be readily recognized that unknown revenue claims, depending on their magnitude could have a significant impact on the success of a s311 scheme, and accordingly a thorough investigation (if this is possible) of the company's history is an essential preliminary step. Therefore, the taxpayer's first duty is to himself, that is; to ensure full disclosure to the Commissioner of Inland Revenue. In that case the assessed or known revenue claims will be protected by the *ratio decidendi* in Nomex as the commissioner will be bound as a creditor by s311 scheme

2.4 Summary

The s 311 schemes of arrangements and compromise have undergone considerable development in South Africa, and there can be little doubt that the law in this area is much clearer and a distinct improvement on that of earlier decades. The uncertainties surrounding the terms "compromise" or "arrangement" have been logically dispelled into sophisticated doctrine with sufficient particularity to afford clear answers to almost all questions relation to 311 schemes. The Appellate Division in Carbon Development and Nomex has put an end to the controversy concerning the jurisdictional requirements of s311 by overruling Robin judgement.

1. See Patterson Australian Company Law ed Vol II at 2374 cited By Coetzee DJP in *Ex parte NBSA Centre Ltd 1987 (2) 783 (T)*
2. *Ex parte Lomati Landgoed (Edms) Bpk 1985 (2) SA 517 (W) at 520*
3. Blackman MS “Compromise, Arrangements, Reconstructions and Amalgamations”, par 56-87 in LAWSA Joubert (ed), Vol 4 Part 3 (‘Companies’), First Reissue (1996), para 57, mentions three procedural steps. Firstly, where a compromise or arrangement is proposed, a person with *locus standi* under the section brings an application to obtain the authority and directions of the court for summoning of meetings of the creditors or members concerned. Secondly, if the court grants the order, the meetings are summoned and held in order to obtain the agreement of the required majority of the creditors or members. Thirdly, if the proposal is agreed to by the required majority or majorities, the sanction of the court must be sought. If sanctioned, on registration by the Registrar of a copy of the court’s order, becomes binding on all creditors or members concerned (whether or not they have all agreed to it) and on the company itself or, if it is being wound up or it is under judicial management, on the liquidator or judicial manager.
4. The Taxpayer “Company schemes of Arrangements: Preserving the Assessed Loss” 26 Vol 38 (2) (Feb 1989)
5. Per Brightman J in *Re NFU Development Trust Ltd [1973] ALL ER 135*.
6. Blackman MS LAWSA *supra* para 59. In *Ex parte Federale Nywerhede Bpk 1975 (1) SA 126 (W)* at 134, where said that there must be countervailing enforceable advantage.
7. Per Brightman J in *Re NFU Development Trust Ltd supra*.
8. *Namex (Edms) Bpk v KBI 1992 (2) SA 265 (A) at 298*.
9. Per Bowen J in *Sovereign Life Assurance Co. v Dodd 1892 2QB 573 at 583*. The test of “commonality of interests” has been previously applied in certain cases, but is now settled that the test is one of “commonality of rights”.
10. Blackman MS LAWSA *supra* makes the point “although in England it has been accepted that such an undertaking on the part of the company is sufficient to constitute an arrangement between the company or its members, our courts have taken the view that it is not sufficient, which is no doubt the better view.
11. *Ex parte Kaplan & others NNO: In re Robin Consolidated Industries Ltd 1987 (3) SA 413 (W)*. For discussion of the quartet of cases see: Jooste RJ ‘Compromise and Assessed Losses’ 26 Income Tax Reporter (1987) 323, Jooste RJ ‘Schemes of Arrangement - Anew Development’ 28 Income Tax Reporter (1989) 7 & The Taxpayer ‘Company Schemes of Arrangement: Preserving the Assessed Loss’ Vol 38 (2) (Feb. 1989)
12. Per Coetzee DJP *supra* at 421J-422A)
13. *Ex parte Millman & others NNO: In re Multi-bou (Pty) Ltd and others 1987 (4) SA 405 (C)*, at 414G

CHAPTER 3
PRIMACY OF ASSESSED LOSS

3.1 Introduction

In closely prescribed circumstances a loss may give rise to a relief from tax by being set off against amount of income and relieving the income from any liability to tax. The foremost and paramount reason for acquiring a company in a parlous financial position is the fact that the company has a sizeable balance of assessed loss which can be used to generate tax-sheltered income.

The tax planning virtues of s 311 schemes of arrangement and compromise can be frustrated by general principles regarding the set-off of assessed loss embodied in s 20. Sections 20(1) read with 20(1)(a) result in the forfeiture or sterilization of assessed where the company did not carry on trade as envisaged. The application of section 20(1)(a)(ii) will result in the elimination or reduction of assessed loss to the extent that a concession has been granted by or compromise made with creditors. In order to avail himself/herself of the full advantages afforded by s 311, the taxpayer must mitigate and circumvent the obstacles placed by s20(1) and 20(1)(a)(ii) in the way of set-off of assessed loss.

Primacy of Assessed Loss is discussed seems easily explainable in terms of the paper's framework of analysis: Assessed loss is the outlet for section 311 schemes or arrangements and compromise urges.

3.2 General Provisions Regarding the Set-Off of Assessed Loss

Sections 20(1)(a) and 20(1)(a)(ii) of the Act 58 of 1962 provided at the relevant time-

Set-off of assessed loss

20. (1) *For the purpose of determining taxable income derived by any person from carrying on any trade with the Republic, there shall be set off against the income so derived by such person*

(a) any balance of assessed loss incurred by the taxpayer in any previous year which has been carried forward from the preceding year of assessment

14. *Ex parte Strydom NO: In re Central Plumbing Works (Natal) (Pty), Ex parte Spendriff NO: In re Candida Footwear Manufacturers (Pty) Ltd; Ex parte Spendriff NO: In re Jersytex (Pty) Ltd* 1988 (1) SA 616 (D)

15. Blackman MS LAWSA *supra* at para 63

16. *Namex (Edms) Bpk v KBI supra* at 294, where it was said that, although when the company merely plays a passive role the arrangement is not one between the company and its creditors; “[d]it is nie nodig dat die maatskappy se aktiewe rol aansienlik moet wees nie”.

17. Levin “The Section 311 Compromise’ 125 BML Vol 21 (1992)

18. *Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd* (In Liquidation) 1993 (1) SA 493 (A) at 504G-H. According to Goldstone J ‘debt subordination is a simple concept, it is the ranking of an unsecured debt upon insolvency of a company. subordination agreements may take many forms. They may be bilateral, i.e; between the debtor and creditor. They may be multilateral include other creditors as parties. They may be in the form of *stipulatio alteri*, i.e; for the benefit of others and future creditors and open to acceptance by them. The subordination agreement entered into some time after the making of the loan”.

19. Per Wunsch J in ITC 1613

20. Getz K & Jooste RJ ‘Section 311 of the Companies Act: Preserving the Assessed Loss’ Revenue Law Jooste (ed) 56, first published as Acta Juridica (1995) Juta & Co. Ltd, at 71

21. *Ibid.*

22. *Ex parte Kaplan NNO: In re Robin Consolidated Industries (Pty) Ltd supra* at 422E-H

23. *Ex parte Millman supra* at 207

24. Per Goldstone J in *Ex parte De Villiers and Another NNO: In re Carbon Developments (Pty) Ltd* (In Liquidation) at 505D-E); where the learned judge makes the point that “the fact that the liabilities of a company exceed its assets does not necessarily mean that the incurring of further debts would constitute fraudulent or reckless conduct. In that context, the existence and terms of a subordination agreement would be material and relevant in deciding whether the persons conducting such business incurred the debts with the reasonable expectation of their being paid in the ordinary course. The fact a major creditor has subordinated its claim and to extent created a moratorium for the benefit of other creditors is obviously relevant in determining the subjective state of mind of the debtor or those conducting its business”.

25. See Luiz SM & E G Hambidge “Compromises and Personal Liability under Section 424 of the Companies Act: Two Judicial Approaches” (1989) 3 SA Merc LJ 123

26. *Namex (Edms) Bpk supra* (headnote 271G-J and 272A-B), See Blackman MS LAWSA *supra* para 67(a) and authorities cited.

Provided that -

(i)

(ii) *the balance of assessed loss shall be reduced by the amount or value of any benefit received by or accruing to a person resulting from a concession or a compromise made with his creditors whereby his liabilities to them have been reduced or extinguished provided such liabilities arose in the ordinary course of trade.*

It would therefore appear that the scope of the deductions for the purpose of assessed loss extends to every admissible deduction (subject to the provisions of any particular provision) under the Act despite the seeming limitation in the definition of “assessed loss”¹.

As with companies s20(1) read with s20(1)(a) allows an assessed loss incurred by the taxpayer company to be carried forward and set-off against income of a later year which derived *from carrying on any trade* within the Republic, by implication, such a balance of assessed loss cannot be set off against such a trade². Further s20(1)(a) envisages a continuity in setting off an assessed loss in every year succeeding the year in which it was originally incurred, so that in each year a balance can be struck which can be carried forward from year to year until it is exhausted. So, for instance, were the company had accumulated assessed loss in year 1, discontinued trading in year 2, there will be no balance of assessed loss to be carried forward to be set-off against income in year 3 and subsequent tax years. The privilege of assessed loss in year is irretrievably lost.

3.3 Discussion of Section 20

To appreciate the general principles relating to allowability of assessed loss relief, discussion of the critical phrases littered in section 20 is order.

3.3.1 Meaning of Income

The uncertainty over the proper construction of the words “income” used in section 20 prevailed in Conshu³. Whatever its demerits⁴, the primary meaning given to the word

“income” in the introductory part of s 20(1) by the majority appears to be compatible with the arithmetic of determining taxable income. Harms JA referred, further to, assessed loss brought forward from the preceding tax year and “ concluded that a ‘a set off in terms of s20 can only arise if there would otherwise have been taxable income’”⁵.

In sharp contrast, the minority thought that the word ‘income’ in s20(1) bore its defined meaning. There was nothing in the Act to indicate that the set-off of an assessed loss could operate only after the other deductions had been made and only if there remained an amount of taxable income as suggested by Harms JA. G J Swart⁶ contends that the view preferred by the majority as to the requirements for the set-off of an assessed loss by a company under s20(1) of the Act conflicts with the history of s20(1) and principles upon which s20(1) is based. Accordingly s20(1) does not require the earning of taxable income or income from trade as the prerequisite for set-off of an assessed loss by a company or of a trade during the tax year.

Although the oppressive results as elucidated by the minority would ensue as result of the meaning given to income in section 20 by the majority, this does not detract from correctness of Harms JA’s construction. If it is possible to place reasonable construction to taxable income in section 20(1), which does not lead to anomalous results as suggested by E M Grosskopf, - then, the majority view is preferred. The only safe conclusion that can be drawn is that “it would be most undesirable for the Revenue not to take not of both the majority’ view as to the meaning of ‘income’ in section 20 and its consequences as spelled out by the minority”⁷.

3.3.2 Derivation of income not required

The principle that derivation of income is not a prerequisite under s20(1) applies to the set-off of assessed -but with difficulty. That s20(1) may be applied even where no income was earned during the relevant tax year, as long as the company carried on trade has not been accepted without demur by some commentators. The views of textbook writers on the issue are not uniform. Thus, E Spiro⁸ justifies the conclusion that there has to be some income from trade against which the set off can operate was inevitable if one followed the letter of the provisions.

In support of this proposition, reference is made to s 20(2A)(b) which specifically provides that a taxpayer other than company shall not be prevented from carrying forward a balance of assessed loss merely by reason of the fact that no income has been derived during a tax year, indicates that a derivation of income is a requirement for the set-off of assessed loss by a company. This seems to be the view favoured by AP De Koker, TS Emslie and CR Frame⁹. In my view this proposition does not take into account the scheme behind the general deduction formula and sections 11-23(g) and the relevant authorities.

In rebuttal G J Swart, points out that “the introductory words of s11 mirror in most respect those of s20(1), for example the deductions provided for in s11(a)-(x) as well as the assessed loss provided for in s20 should be deducted from a set-off against the income” derived by [the taxpayer] from carrying on “any trade within the Republic”¹⁰. It is so widely formulated, G J Swart says, that “a company must earn income before it can set-off an assessed loss from the past immediately raises the question why the derivation of income is not seen as a requirement under s11”¹¹.

I must respectfully associate myself with this explanation relying, as it does on the scheme behind the general deduction formula and line of authorities. That expenditure and losses can, in terms of the general deduction formula, be deducted from trade to the extent to which they were incurred, laid or expended in the production of income (ss11(a) and 32(g)) finds support in the judgement of the Appellate Division in SIR v Guardian Assurance Holdings (SA) Ltd¹² and CIR v Nemojim (Pty) Ltd¹³. Also, expenditure will not be disqualified as a deduction if it produces no income in the tax year in which it is incurred or if it eventually fails to produce any income as long as it was incurred for purposes of earning income in that year or a future year. The argument that deductible expenditure must have demonstrable result on the taxpayer’s income was also rejected in KBI v Van der Walt¹⁴.

It follows that the absence of a profit will not necessarily disqualify an expense as an allowable deduction. The remarks of Corbett JA (as he then was) in De Beers Holdings (Pty) Ltd, are apposite

“..... *the absence of a profit does not necessarily exclude a transaction from being part of*

the taxpayer's trade, and correspondingly money's laid out in a non-profitable transaction may nevertheless be ... expended for the purpose of trade within the terms of s23(g) such moneys may well be disbursed on the grounds of commercial expediency or in order to indirectly facilitate the carrying on of the taxpayer's trade¹⁵

This leads the learned author to conclude with reference to s20(1), that it recognizes that the allowable expenses may exceed the taxpayer's income by allowing taxpayers to carry forward such excess to a following tax year as an assessed loss. The object of s20(1) is clearly to provide for the recovery *in future tax years*, of expenditure and losses not recovered in full from income from trade during a tax year. This function was implicitly recognized in Lockie Bros Ltd¹⁶.

3.3.3 Meaning of "Balance of Assessed Loss"

An "Assessed loss" is defined, for the purpose of s20, as "any amount by which the deductions" admissible under sections 11-19, inclusive, exceed the income in respect of which they are so admissible."

The passage in Income Tax Cases & Material¹⁷ provides an apt explanation of the expression 'balance of assessed loss'. The expression 'balance of assessed loss' in s20(1)(a) refers to the situation where the income or taxable income of a particular year is more than swallowed up by deductions, a current year's assessed loss of a previous year, resulting in a balance of assessed loss which can be carried forward to be set-off against the income of that year. If in a year (year 2) subsequent to that in which such balance was ascertained (year 1) the taxpayer derives no income from carrying on a trade against which balance can be set-off, a fresh balance of assessed loss to be carried forward, then, in the following year (year 3); the taxpayer is precluded from setting off the initial balance (i.e. from year 1) against its income by the requirement that the balance to be set off must have been carried forward from the preceding year of assessment (year 2).

ITC 664 sums up the balance of assessed loss in the following terms:

"Assessment are made on yearly basis and if there be no income in any particular year, all that is revealed in such a case is a minus quantity, not a balance. Hence one is thrown back to the

original loss or balance of assessed loss, the set off of which is negated by the requirements that it must have carried forward from the preceding year of assessment”¹⁸.

As appears from the analysis of ITC¹⁹ 664, it is this excess (‘balance of assessed loss’) that may be carried forward to the succeeding year of assessment. Alternatively, if an assessed loss arises from the trading operations of the current year, and it is the aggregate loss that represents the balance of assessed loss to be carried forward to the next year of assessment for the set-off against the income.

The carry forward is from ‘preceding year’. It follows that if in a particular year no balance of assessed loss is determined in preparation for future use, there cannot, be in the subsequent year, a looking to past²⁰ A ready made example of this would SA Bazaars (Pty) Ltd²¹, where the courts held that it was not competent for a company which had discontinued trading within the meaning of section 11(1) in a particular year, to set-off in its income tax return for that year the balance of assessed loss incurred by it in previous year. Mercantile abstinence can result in forfeiture of the relevant assessed loss.

3.3.4 Meaning of “Ordinary Course of Trade”

The privilege of assessed loss relief does not apply where a company did not carry on trade during the tax year. The taxpayer is saddled with the onus of showing that the activity in question is attributable to trading activity within the context of s20(1). It is a question of fact whether the taxpayer’s activities amount to carry on trading. Section 20(1)(a)(ii) refers to “liabilities arising in the ordinary course of trade”. This would appear to have wider application than the recoupment provisions which specifically refer to recoupments of expenditure deductions allowed in terms of sections 11 to 20 of the Act.

This was nicely illustrated in an earlier Rhodesian case, A v Commissioner of Taxes²², the court held that where a subsidiary had borrowed money from its holding company at a nominal rate of interest, this was a liability arising in the “ordinary course of trade”. The judgement refers to the case of Down Distributing Co. (Pty) Ltd v Associated Blue Star Store (Pty) Ltd, CLR 463, where the court was concerned with the interpretation of a similar expression. Rich J said of the expression:

“It means that the transaction must fall into place as part of the undistinguished common flow of business done, that it should form part of the ordinary course of business as carried on, calling for no remark and arising out of no special particular situation”²³

Goldin J then suggests;

“The motives which induce a creditor to lend money at all or an unusually easy or desirable terms not relevant consideration ... The fact that the lending of money was not part of the creditors trade or that the loans were not made in the ordinary course of the creditors trade is not relevant”²⁴.

Although the court was not called upon to decide the point, there is suggestion that liabilities incurred on capital account would not be included as a liability arising in the “ordinary course of trade”. Meyerowitz and Spiro²⁵ suggest that s20(1)(a)(ii) is open and that liabilities arising from capital expenditure, ie; expenditure not taken into account in determining the taxable income.

Recently, the Special Court²⁶ has sought guidance on the badges of trade from an instructive judgement of Sir Nicolas Browne-Wilkinson, then Vice-Chancellor, in Mason v Morton (1986) 1 WLR 1343 (ChD)²⁷. Wunsh J dealt with the question whether profit realised on sale of diamonds was receipt of capital or revenue nature.

Farming investment portfolio

It is firmly established that the carrying on trade involves an active step something far more than merely watching existing investments which are not intended or expected to be, income producing during the year in question . Let us look more closely at ITC²⁸ 1476, which established that “if a company once carried on a trade it does not follow that, as long as it retains its investments, it therefore continues to trade. It may retain its shares and investment previously required but cease on a trade again. The Special Court declined to accept that activities of the company in which the taxpayer held investments constituted carrying on a trade on behalf of the taxpayer company. In reaching a decision adverse to the company, Kirk-Cohen J, considered in the light of probabilities, that the appellant has not established that it endeavoured to perform any act during that year which would have constituted carrying on a trade in terms of the judgement of Nesor J.

It is essential that the company keep a constant watch over its investment portfolio and 'farming' it assiduously.

Interruption of trading activity

Temporary closure of a company's business may result in the forfeiture of assessed loss, as it will be regarded as not carrying on a trade as long as it keeps its business closed, even if it intends resuming its trading activity at a later date. Aubrey S Silke²⁹ contends that in order to alleviate this oppressive result, the carry forward of a loss should be permitted where a company has through no fault of its own not been able to carry on business activity during the year.

The section 20(1)(a) consequences of interruption of trade has been reliably fixed in both SA Bazaars (Pty) Ltd³⁰ and New Urban Properties Ltd³¹. In the former case it was held that s20(1)(a) properly interpreted, means that where a taxpayer has not traded at any time during the current tax year, there is nothing against which the assessed loss brought forward from previous year can be set off in that year. In the latter case this logic was taken step further, and the court held that such a situation there is no "balance of assessed loss" to be carried forward into the following year. It is a question of fact whether a particular activity constitutes trading within the meaning of s20(1)(a). A number of cases have previously been taken on to the courts to determine the existence or absence of carrying on a trade in terms of s20(1) during the relevant year of assessment. The decisions of their lordship Page J and Schutz JA in both Timberfellers Ltd³² and Robin Consolidated Industries Ltd³³ respectively have added the lengthening list.

Collecting pre-liquidation debts

The reasoning of the Timberfellers' court is that collection of outstanding pre-liquidation debts, in the circumstances did not constitute carrying on a trade. The relevant facts were as follows. The taxpayer encountered financial difficulties leading to final liquidation until an offer of compromise sanctioned in terms of s 311 of the Companies Act. Following s 311 compromise and restoration to solvency, the company collected outstanding debts in order to enable McCarthy to recover, in so far as he could, the amounts to which he was entitled

through the loan account of Sharon Air (Pty) Ltd, not one cent in the money collected was utilised or made for trading activity on the part of appellant and it was clearly not intended too further such any activity.

Page J said it was clear that;

“The question of whether the collection of debts constitutes trading has been considered in a number of cases whilst the recovery of monies owing as result of a transaction in the course of trade is, of necessity, an integral part of that transaction, the effect of the case law is that this, in itself, does not necessarily mean that such recovery amounts to carrying on trade”³⁴.

The case of Merchant v Commissioner of Taxes³⁵ was cited as support for the proposition that the collection of debts; per; was insufficient to constitute carrying on trade” In casu the collection of debts was analogous to making available as capital of the monies earned prior to the placing of the company in liquidation before disposing of it to the party.

But there is a glimmer of hope in the Timberfellers case. The court acknowledged that a party may carry on trade within the meaning of s20(1) -through the agency of another and there is nothing in the section to warrant a limitation of its ambit to trade carried on by the taxpayer personally or to exclude the operation of the ordinary rule that *quid per alium per se*; if the collection of debts which took place through the agency of others does amount to carrying on a trade, then; their actions should be regarded as those of the taxpayer for the purpose of the section.³⁶

The foregoing authority mandates the conclusion that whether debt collection amount to carrying on a trade is a question of fact.

Inactively carrying on trade

The main issue before the Appellate Division in Robin Consolidated Industries Ltd. was whether the sales in question were effected in the course of their trading activities and whether the company did carry on a trade in the 1988 year of assessment.

With regard to trading in a state of limbo, his lordship said it was clear that:

“the creditors had decided to bring an end to trading as soon as this could be advantageously done and they had accepted an offer to purchase from which was excluded the stock bond and thereafter no trading venture was to commence - certainly no trading venture in any ordinary sense”.³⁷

Cases referred on this aspect included J & R O’Kane & Co³⁸ and ITC 172 (1930) 5 SATC 171³⁹, which supported the proposition that the disposal of the stock was designed to allow others to trade and the circumstance in which the stock in bond was sold in the instant case were not of the same genre. The learned judge said he was entitled to conclude that:

*“while the replenishment of stock is an indicium of trading, there was none of that present in casu, but rather, positive steps were taken to see that the appellant did not receive stocks already destined for it, the stock in transit and in bond”*⁴⁰.

Accordingly the disposal of the stock in bond was designed to allow other to trade in stock and release appellant from the risks entailed in doing so itself.

Counsel for the appellant, in the second submission sought from their lordship - the unusual course of having the Appellate Division depart from the line authoritatively laid down by his lordship Centlivres JA in SA Bazaars (Pty) Ltd. It was established that a set off of assessed loss would be measured against (a) income derived from trade and (b) where the balance of assessed loss has been carried forward from the preceding year. This was later reinforced in New Urban Properties Ltd, where it was said that a balance can be carried forward from any year only if a balance has been struck in that year, which clearly means: if in year reflecting the balance of assessed loss at the end of it.

The principal contention advanced by counsel was “that for any balance to have been assessed for that year as only assessed losses can be carried forward from that year immediately preceding it must have been assessed for that year as only assessed losses can be struck in that year”. Reliance was unsuccessfully placed on the construction of s 20(1). In this regard Schutz JA said the following:

“..... the attribution of excessive tautology to the legislature and a failure to read the words as they are, thus part of the appellant argument falls short of demonstrating that the

*construction adopted in the two case, SA Bazaars case and New Urban Properties Ltd case, is wrong, even loss, clearly, in fact it is correct and this disposes of argument that the second proposition in the SA Bazaars is wrong as not being based on the subsection”.*⁴¹

Therefore there was no compelling reason for departing from antecedent *dicta*, and “*That once the meaning of the words of section in an Act of Parliament have been authoritatively determined by it, that meaning must be given to them, even by this court, unless it is clear to it that it has erred*”.⁴²

In summing up the Court’s robust stance, his lordship highlighted the potential dangers of detouring from the *stare decisis* when a decision has been acted on for decades in such a manner that rights have grown under it,”

“*That forty-five years businessmen and the Revenue have been ordering their affairs on the assumption that the SA Bazaars case laid down the law and there has been no material change in the context in which the rule in that case operates, so that this would have been a especially slow to depart from its earlier decisions*”.⁴³

It was further emphasised that “*in order to succeed, appellant has to overcome both propositions in the SA Bazaars case, and on the second appellant must fail, in regard to the first proposition (set off only against income derived from trade), appellant conceded, and correctly so, that the proposition was properly derived from the section*”.⁴⁴

In short, the survival of balance of assessed loss carry forwards stands and falls on the taxpayer establishing continuity of trading activities. Mercantile abstinence during a tax year may prove to be fatal to set-off of an assessed loss -and could result in forfeiture of assessed loss.

3.3.5 Carry on Discriminating

One general remark before quitting this branch of the subject. The trade requirement for the set-off of assessed loss has been fruitful of controversy because of its discriminatory effect. There has never been compelling justification in principle for such potential discrimination⁴⁵. It remains to consider the only difference between the position of companies and that of persons other than companies -a company is precluded from utilizing an assessed loss from a previous

year in which there was mercantile abstinence. I allude to these facts only to show that, so far from violating the precept of horizontal equity -its also susceptible to constitutional challenge.

3.3.6 Meaning of “with his creditors”

The ceiling which governs the application of s20(1)(a)(ii) is that a concession granted by or compromise made “with his creditors”.

The issue before the Special Court in [336] NO 8558⁴⁶ was whether a compromise made with, or a concession granted by, a single creditor does not fall within the scope of s20(1)(a)(ii). Support for this proposition is found in the Rhodesian *dicta* in Blue Moon Investment (Pvt) Ltd⁴⁷. Section 20(1)(a)(ii) did not specifically require the concession to be granted by, or the compromise to be made with, the general body of the taxpayers’s creditors: The plural used in the subsection includes the singular, and a concession by or a compromise with a single creditor can reduce the amount of a balance of assessed loss.

3.4 Application of Section 20(1)(a)(ii)

Before looking at the application of section 20(1)(a)(ii), it will be convenient to mention that there is no concession or compromise merely because creditors write off the taxpayer’s liability as a bad debt.⁴⁸ It becomes clear, therefore, that a debt written remains legally enforceable. In nutshell to constitute a concession or compromise by the creditors is binding on them.

Literal reading of section 20(1)(a)(ii) would seem to provide that the balance of assessed loss that is to be reduced by the value or amount of the compromise benefit, is the balance of assessed loss as existing at the beginning of the year of assessment in which the compromise is reached with the creditors. In, Louis Zinn Organization (Pty) Ltd, it was held that the balance of assessed loss that is to be reduced by the compromise benefit is the balance of assessed loss as existing at the end of the year of assessment during which the compromise benefit accrued.

With Louis Zinn Organisation (Pty) Ltd case should be contrasted with the finding of the

Special Court which concluded that:

“this subsection, it will be seen, makes specific provision for the deduction of the amount of a benefit of this nature from an assessed loss in a prior year which has been brought forward. There is no provision for the deduction of such an amount from a loss in the current year. The very clear wording of the section limits the deduction to one from an assessed loss brought forward from a prior year”.⁴⁹

Speaking for himself and the members of the Appellate Division, Schreiner ACJ, explained that in dealing with the term “balance of assessed loss”, it should be kept in mind that:

“although at the stage where it is to be used, i.e. when it is set off against a profit, a balance of assessed loss looks back to the past, at the stage where it is being determined i.e. when its amount is being calculated, it looks forward to the future when it will be rejected”.⁵⁰

With reference to the section which provides that “the balance of assessed loss shall be reduced”, Schreiner ACJ said that the paragraph was referring to the stage of application or to stage of determination. He considered that the word “reduce” is more appropriate to the determination stage, since:-

“once the balance of assessed loss is determined you cannot really reduce it- you can only reduce its effect by countering it with another amount”.⁵¹

In my view, the taxpayer should be given the benefit of the ambiguity of the section.

An example of this application as interpreted by the courts is as follows⁵²:

JCI Ltd has an assessed loss of R 320 000 at 31 December 1997, its year end. In February 1998 it entered into a compromise with its creditors whereby its liabilities to them were reduced by R 260 000.

1. Assume for the year ended 31 December 1997 the company made a taxable profit of R320 000, before the set-off of the assessed loss brought forward.

Taxable profit	R 350 000
Less assessed loss	<u>R 320 000</u>

Taxable income	<u>R 30 000</u>
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As there is no “balance of assessed loss” existing at the end, there is no set-off of the compromise benefit.

2. Assume that for the year ended 31 December 1997 the company made a taxable profit of R250 000 before the set-off of the assessed loss brought forward.

Taxable profit	R250 000
Less assessed loss	<u>R320 000</u>
Balance of assessed loss	<u>R 70 000</u>
compromise benefit	
(limited to balance of assessed loss	
Assessable loss carried forwards to 1998	<u>NIL</u>

Although the company itself will no taxable income for the year, the balance of assessed loss will not be carried forward to 1998 as it is extinguished through the set-off of the compromise benefit.

3.4.1 Computation of the amount or value of the benefit

It is common ground that the trigger for the application of section 20(1)(a)(ii) is the amount or value of benefit as result of concession granted by or compromise made with creditors. Once it is determined that a company has derived a benefit from the concession granted by or compromise made with creditors, the Commissioner is saddled with an onus of quantifying the aforesaid benefit. One of the problems sometimes encountered in applying section 20(1)(a)(ii) is whether or not the benefit value or amount is quantifiable. It has long been settled that a benefit has an amount or value if it is moneys worth or can be turned into money. It has been emphasised in cases such as Butcher Bros (Pty) Ltd⁵³ and H.W. Lategan⁵⁴ that to be an “amount” something must have an ascertainable money value. In this context the reasoning of Hefer JA is worth quoting in full:

“It must be emphasised that income in a form other than money must, in order to qualify for inclusion in the “gross income” be of such a nature that a value can be attached to it in money. As Wessels CJ said in the Delfos case (supra) at 251,

*‘The tax is to be assessed in money on all receipts or accruals having a money value. If it is something which is not in money’s worth or cannot be turned into money, it is not to be regarded as income’*⁵⁵

As Wunsh J observed in ITC 1613,

*“There are, other provisions of the Act, prescribed methods for determining amounts or values - see, for example, paras 5(e) and (I) of the definition of ‘gross income’ in section 1. Section 8A(3) is another part of the Act which establishes the ways in which an ‘amount’ must be ascertained (the guidelines of a gain made or even guidelines are given for the application of section 20(1)(a)(ii))”*⁵⁶.

In view of section 82, the Commissioner is saddled with formidable and difficult onus proving or ascertaining the value of the benefit accruing to the taxpayer. If the Commissioner fails to establish the amount or value of a compromise benefit or any of the quantified figures, the assessed loss in question will not be reduced or obliterated by invocation of section 20(1)(a)(ii). All in all the assessed loss will survive the Commissioner’s counter attack under the relevant provisions of section 20(1)(a)(ii).

1. Meyerowitz On Income Tax (1997-1998) para 12-125
2. Williams R C Income Tax in South Africa Law and Practice, pp 303
3. *Conshu (Pty) Ltd v CIR* 1994 (4) SA 603 (A), 1995 Taxpayer 87, 57 SAT Cases 1.
4. *Conshu supra*, E M Grosskopf adverted to the practical effect of the construction of the word 'income' preferred by Harms JA. It would be absurd as pointed out by the minority if a company which incurs a loss in years 1 and 2 the loss in year 1 could be carried forward to year 3 because of the continuity of the set-off required and further loss was made in the current year. See TS Emslie et al Income Tax Case & Materials, 1 p 187. For full discussion see GJ Swart "The Utilization of Assessed Loss by Companies -A Reappraisal After Conshu (Pty) Ltd v CIR (1996) 8 SA Merc LJ 1119, at 128 -133. Swart subscribes to the construction of the word 'income' in section 20(1) bore its defined meaning as expounded by the minority. On the other hand, TS Emslie writing in The Taxpayer "Some Thoughts on Conshu' (unpublished) is more explicit in support of the majority view, but with qualifications, and the remarks are apposite: " Having come down in favour of the majority view of the meaning of 'income' as meaning 'taxable income' in s20(1); however, we nevertheless agree with the minority' conclusion (albeit for different reasons) that nothing in s20 suggests that a balance of assessed loss is irretrievably lost just because a further assessed loss arises in the succeeding year of assessment". pp 2
5. Per Harms JA in *Conshu supra* at 612 - 613
6. Swart GJ *supra*, at 130 - 131
7. The Taxpayer "The Conshu case", Taxpayer Vol 42 (5) (May 1995) 81, p82
8. Spiro E 'Income Tax Deduction -Whether Balance of Assessed Loss Prior to Non-Trading Period Thereafter Deductible" (1952) 1 The Taxpayer 213 ,at 214 referred by Swart GJ *supra*, p130
9. De Koker. Emslie TS and Frame CR Income Tax in South Africa (1988) at \$11.35 p248 cited by Swart GJ *ibid*.
10. Swart GJ *supra* 130 -131
11. *Ibid*.
12. *SIR v Guardian Assurance Holdings (SA) Ltd* 1976 (4) SA 522 (A)
13. *CIR v Nemojim (Pty) Ltd* 1983 (4) SA 935 (A)
14. *KBI v Van der Walt* 1986 (4) SA 303 (T), at 309G
15. *De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (A) 67 SATC 229, 1986 Taxpayer 8, , at 36H-J.
16. *Lockie Bros Ltd v CIR* 1922 TPD 42 at 44

17. TS Emslie *et al* Income Tax Cases & Materials "Assessed Losses" para. 18.1. p 815
18. ITC 664 16 SATC 125, *supra*, at 126
19. ITC 664 16 SATC 125, *supra*, at 127
20. Van Dorsten J L 'Words & Phrases Judicially considered', p 71
21. SA Bazaars (Pty) Ltd v CIR 1952 (4) SA 505, 18 SATC 240, 1952 Taxpayer 213
22. *A v COT* 1954 (1) SA 38 SR), 19 SATC 29
23. *Downs Distribution Co. (Pty) Ltd v Associated Blue Stores (Pty) Ltd*, CLR 463, at 477
24. In delivering judgement in *A v COT* 1954 1954 (1) SA 38 (SR), 19 SATC 29
25. Meyerowitz D, Spiro E, The Taxpayer's Permanent Volume on Income Tax in South Africa at para 864
26. See ITC 1603, 59 SATC 63
27. *Mason v Morton* (1986) 1WLR 1343 (ChD) referred to and discussed in ITC 1603 54 SATC 63
28. ITC 1476 52 SATC 141, 1995 Taxpayer 53
29. Aubrey S Silke Tax Avoidance and Tax Reduction Within the Framework of the South African Income Tax Legislation with Special Reference to the Effect on the Fiscus and to Current Anomalous and Inequities (1958) \$ 165 p325 in Swart GJ *supra* 133.
30. *SA Bazaars (Pty) Ltd v CIR* 1952 (4) SA 505 (AD) 18 SATC 240, 1952 Taxpayer 213
31. *New Urban Properties Ltd v SIR* 1966 (1) SA 217 (A), 27 SATC 173, 1966 Taxpayer 12
32. *Timberfellers (Pty) Ltd v CIR* 1994 (4) SA153 (D)
33. *Robin Consolidated Industries Ltd v CIR* [1997] 2 All SA 1995 195 (A)
34. Per Page J in *Timberfeller v CIR supra* at 163
35. *Merchant v COT* 1944 (SR) 96 at 100 referred and cited by Page J in *Timberfeller (Pty) Ltd supra*
36. *Timberfellers (Pty) Ltd supra* at 157
37. Per Schutz JA *Robin Consolidated Industries Ltd v CIR supra* at 208
38. *J & R O'Kane & Co. v The Commissioner of Inland Revenue* 12 TC 303 (HL) referred to and discussed in *Robin Consolidated Ltd supra* at 206

39. ITC 172 (1930) 5 SATC 171 referred to and discussed in *Robin Consolidated Industries Ltd supra* at 207. The finding of the Special Court was that “in the circumstance of the case the gradual disposal of the assets over number of years on the terms and conditions as the company dealt with them and disposed of them prior to liquidation amounted really to a carrying on of its business, and under these circumstances the amount so received is part of the company’s gross income ...”. at 174
40. Per Schutz JA *supra* at 208
41. Per Schutz JA *supra* 208
42. Per Schutz JA *supra* 210
43. Ibid.
44. Ibid.
45. Swart GJ *supra* at 133.
46. Special Court Case NO 8558 [336] Income Tax Cases & Materials, p 835
47. *Blue Moon Investment (Pvt) Ltd v COT* 1966 (4) SA 205 (RAD).
48. Meyerowitz on Income Tax 1997/1998 para 12.142
49. *CIR v Louis Zinn Organisation (Pty) Ltd, supra* at pp 93
50. *CIR v Louis Zinn Organisation (Pty) Ltd, supra* at pp 95
51. *CIR v Louis Zinn Organisation (Pty) Ltd, supra* at pp 95
52. See also Meyerowitz Meyerowitz On Income Tax para 12.129
53. *Butcher Bros (Pty) Ltd* 1945 AD 301 a pp 318 n- 321 referred to and discussed in ITC 1613 *supra*, at pp195
54. *WH Lategan v CIR* 1926 CPD 203 at p 209, referred and cited in ITC 1613 *supra* at pp 195
55. *CIR v Peoples Stores (Walvis Bay) (Pty) Ltd* 1990 (2) SA 353 (A) referred to and discussed in ITC 1613, *supra* at pp 195
56. Per Wunsh J ITC 1613 *supra*, at pp 195

CHAPTER 4

RETENTION OF ASSESSED LOSS

4.1 Introduction

As indicated the primary explanation for the proposer availing himself/herself of the machinery provided by section 311 is not necessarily to rescue insolvent from provisional liquidation, but the company's accumulated assessed loss. Effecting section 311 scheme does not necessarily translate into a tax advantage as result of operation of section 20(1)(a)(ii). It is provided by section 20(1)(a)(ii) that the compromise must have been between the company and its creditors, and only then will the balance of assessed loss to be carried forward to the next year of assessment be reduced by the value of the compromise benefit.

It becomes clear that if a person acquiring a company wishes to preserve an assessed loss which the company might enjoy for tax purpose, the amount or value of any concession must be kept to an absolute minimum. The company's assessed loss will be eroded to the extent of the amount of any concession by or compromise with creditors.¹

This chapter will therefore explore possible strategies by which an insolvent company's assessed loss can be preserved. Tax planning, however, always makes a good deal even better.

4.2 Avoiding the Provisions of Section 20(1)(a)(ii)

4.2.1 Acquisition of Creditors' Claims by the Offerer

In general to overcome the negative effects of s20(1)(a)(ii), the one suggested route is to buy out the creditors' claims against the company for a reduced sum, usually equal to the amount the creditors would have accepted as compromise with the company. This offer to purchase the creditors' claims is conditional upon the offeror acquiring the share capital in the company and the release of the company from provisional liquidation. Indeed, if prudent, having acquired the creditors' claims, the offeror then enters into a compromise with the company, whereby his newly acquired claims against the company are reduced by a nominal amount, usually R1 per claim or one cent in the rent. In this way the compromise benefit, except for the nominal reduction has effectively been transacted 'outside' the company and the assessed loss of the company remains substantially intact.

Moreover, the offeror has acquired large claims against the company (usually transferred to a loan account), which claims can be repaid to the offeror, potentially free of tax, once the company returns to a profitable position².

4.2.3 Realization of Claims by the Offeror

Whether or not the excess between the amount received on a subsequent realisation of the claims and the amount paid for these is taxable will depend on whether such an amount forms part of gross income of the offeror or not.

In section 1 gross income is defined as meaning:

“in the case of any person, total amount in cash or otherwise, received by or accrued to or in favour of such person during such year or a period of assessment, from a source within or deemed to be within the Republic excluding receipts or accruals of capital nature”

For the purpose of determining whether the proceeds on realisation of the claims fall into gross income as defined will depend primarily on whether or not the offeror is carrying on a trade or scheme of profit making and whether the amount received constituted capital or revenue. The term trade is defined to include:

“every profession, trade, business, employment, calling, occupation or venture”

There have been many cases where the courts have made distinction between individuals and companies in determining whether the taxpayer was carrying on a business or not. Wessels C J in CIR v Stott stated the law as follows:

*“As a general rule, one or two isolated transactions cannot be described as the carrying on of a business. A single undertaking may be of such a nature that can be correctly described as a business. If you are dealing with a company one of whose objects is to buy and sell land, then the company might well be considered to be doing business of buying and selling land even though it carries out only a single transaction, but when an individual like a surveyor who is not professional carrying on the occupation of a land jobber buys and sells one or more plots of land cannot be said prima facie to be doing the business of a land jobber. Before it can be said that an individual is carrying on a business there must be some proof of continuity.”*³

It is quite well settled principle that it is not an essential requirement that a taxpayer be carrying

on a trade or business in a particular type of asset in order for the proceeds derived from the realization of such an asset to be regarded as income subject to tax. But equally established is that the real test depends upon the intention or motive behind the transaction and whether there is a scheme of profit-making involved⁴. The onus of proving that any receipt is of a capital nature is on the taxpayer. He must establish the facts from which the desired inference can and should be properly drawn. In a case⁵ where a taxpayer acquired for a nominal value shares and loan account in a company with an assessed loss with the specific intention of diverting income to that company and utilising the income to repay his loan account in full, it was held that the taxpayer was carrying out a profit-making scheme and he was accordingly taxed on the proceeds of the loan account.

If the object of the share acquisition is to make an investment and the debt is acquired as “part and parcel” of the whole transaction is one of capital nature, so that if the debt is acquired at a price which is below the face value, any profit made on the collection of the debt is one of a capital nature. On the other hand, if there is a dual intention in acquiring the shares and debt, i.e. to acquire the shares as an investment and to acquire the debts as part of a profit making scheme, the profit on realisation of the debts will form part of gross income. It is submitted that the majority of “section 311 schemes” which follow route mentioned earlier, would fall into this category. A diversion of income to the company and an early repayment of the claims would enhance this view.

If the acquisition and subsequent realisation of the claims form part of a scheme of profit-making, the claims when acquired, will be regarded as trading stock in the hands of the offeror. The definition of “trading stock” in section of the Act 58 of 1962 read at the relevant time:-

“Trading Stock” “includes anything ... purchased or in any other manner acquired by a taxpayer for the purposes of ... sale or the procedure from the disposal of which forms or will form part of gross income”

The Act further provides :-

“That the amount .. Which shall be taken into account in respect of the value of any trading account in respect of the value of any stock held and not disposed of by him shall be the cost price to such person of such trading stock.....”

As was stated in De Beers (Pty) Ltd⁶, the definition of ‘trading stock’ in section 1 of the Act may be notionally and grammatically divided into two parts - the first part lays emphasis upon the purpose for which anything may have been produced, manufactured, purchased or in any other manner acquired by a taxpayer - the specified purposes are manufacture, sale or exchange by the taxpayer or on his behalf; the second part makes no direct reference to any purpose which the taxpayer has had at the time of acquisition - it postulates an objective assessment, namely whether if the thing under consideration was disposed of, the proceeds would form part of his gross income.

To illustrate: in each year of realisation a problem might arise in determining the cost of the claims purchased from the decisions from the creditors were not all on the same terms. For example, secured claims may have been purchased for full value and concurrent claims purchased for say 100 - in the rand. As the claims would have all effectively been merged into one claim (usually loan account) it will be extremely difficult to identify which claim has been realised in each year. and therefore the cost to be excluded from the offeror’s closing stock for that year of assessment. Presumably in such instances the cost of acquiring the total claims would be apportioned proportionately to the amounts realised.

In order to avoid this type of situation it is suggested that the different classes of claims acquired be separately identifiable in the company’s balance sheet and in the offeror’s trading account.

4.3 Ways of Preserving Assessed Loss

4.3.1 The Standard Scheme

On answer to avoiding the provisions of section 20(1)(a)(ii) has already been discussed. The thrust of the standard scheme has been succinctly described by Selikowitz in Namex.

“The ‘standard scheme’ is essentially one which the offeror makes sum of moeny available to a “receiver” who is required to distribute it, as a dividend, to the creditors of the company in liquidation. In return for the dividend, the creditors lose all further rights against the company. Their claims, however, persist, and are ceded or deemed to have been ceded to the offeror who thereby acquirers a loan account effectively equal to the company’s total existing liability. It is also usual that the claims of the creditors are reduced by a nominal amount (for example one

cent in the rand). The last provision was developed in an effort to establish that the scheme was, in fact, one between the company and its creditors - as is required by s 311 of the Companies Act -and not merely between the offeror and the creditors. It is also common for the scheme to be made conditional upon the offeror gaining control of the company and the liquidation order being set aside. The effect of the 'standard scheme' is to vest control of the company in the offeror who acquires a "clean company", i.e. one without outside creditors. The offeror can seek to take advantage of any assessed losses in the company and can use his loan account to draw income from the company with tangible tax benefits".⁷

After what threatened to a major setback to its rapid development⁸, but proved to be mere 'hiccup', the standard scheme has been restored to full effect. It will therefore be recognised that, although the Appellate Division has not explicitly approved the 'standard scheme', there are persuasive *obiter* indicating that, if it were compelled to address the issue, it would possibly come down in its favour. If this were to happen, the legal position would revert to that which obtained before the Cape and Transvaal court upset the apple cart⁹

4.3.2 Partial Cession Scheme

In the footsteps of the standard scheme followed partial cession scheme as a corrective to the perceived defects of the latter scheme. In the Multibou¹⁰ case the Court declined to put stamp of approval on the Partial Cession scheme. The essential feature of the proposed scheme was that the acquirer would receive, by way of cession, 99 percent creditors' claims against payment of a stipulated amount. The company would then borrow on loan account from the acquirer a further amount to be paid to creditors for the remaining one per cent of their claims. Both amounts would be paid to receiver who would be responsible for making a distribution to creditors on sanction of the scheme.

If sanctioned would preserve the assessed loss, thus rendering s20(1)(a)(ii) inoperative. The court further rejected the arrangement on the ground that it was a sham, a disguised or simulated transaction. It was structured to give the appearance and impression of an arrangement between the company and its creditors. When in substance it was an arrangement between the offeror and

the creditors.

4.3.3 The Preference Share Scheme

Another more popular method of preserving assessed loss is through the preference share scheme route. The essence of this type of scheme is that the claims of the creditors, as reduced by a capital amount paid to them in terms of the scheme. They are converted into preference share capital and the creditors are then deemed to have renounced their entitlement to the issue and of a person (usually the offeror) nominated by the company. The rights of the creditors under such arrangement are confined to the right to claim payment of the dividend receivable by them under the agreement. As explained in Bolstone¹¹ the preference share scheme route is on all fours with the jurisdictional requirements of section 311 (ie. that the arrangement is indeed one between the company and its creditors). It was correctly pointed out that the company was directly involved, and reference was made to the fact the scheme required the company, inter alia; to pass a resolution to capitalise the creditors' claims, to issue shares and to pay the capital sum to the creditors.

The hardest question is whether the preference share method preserves the company's assessed loss. This returns us, full circle to section 20(1)(a)(ii). The interaction between preference share scheme and s20(1)(a)(I) has become a contentious issue in South African law¹².

To this point, the core premise advanced by the proponents of the preference share scheme is that the liability to repay a debt of a certain amount has been replaced with a liability to redeem preference shares at a value equal to the amount of the debt, place it beyond the reach of section 20(1)(a)(ii). It bears mentioning that the form of the liability has changed, the amount thereof is the same as before and accordingly the company has not received a benefit from the scheme sufficient to reduce the assessed loss¹³.

In rebuttal, The Taxpayer¹⁴ suggests that the preference share scheme would fall foul of s20(1)(a)(ii). It submits that a benefit does accrue to the company but what is difficult to adjudicate is whether the benefit result from a concession granted by or compromise made with its creditors. The Taxpayer submits that a persuasive approach is to examine the *quid pro quo* to

which the creditors become entitled of their claims, if it is adequate then there is no concession must have been granted or compromise made. Reference is further made to an Australian decision (Grant v federal Commissioner of Taxation¹⁵) as highly instructive in this regard. In this case the taxpayer paid \$97 000 for allotment of 97 000 preference shares at \$87 770. Notwithstanding the fact that in terms of company law it was not possible to pay less than \$97 000 for the allotment of 97 000 & 1 par value preference shares. The taxpayer was held liable for gift duty on the difference between the amount paid and the market value of the shares allotted. However, in a minority judgement Jacobs J held that as lawful minimum had been paid for the preference shares the allotment received was lawful minimum consideration for the money paid and there no liability for gift duty¹⁶.

Further, The Taxpayer¹⁷ considers the question whether a compromise or concession has been granted or made where creditors receive for value of preference shares for the face value of their claims to be directly analogous. On the other hand, if the shares to which the former creditors become entitled notwithstanding that in the present context entitlement is renounced in favour of a third party, have a market value of less than the amount of the claims, then a concession by the creditors would seem to have been granted. Perhaps a municipal court may adopt the approach of Jacobs that since the lawful minimum has been paid for the par value preference shares no concession or compromise can objectively be said to be present.

The Taxpayer refrains from speculating on which approach is likely to be followed in South Africa although the journal states that it inclines towards the majority view in the Grant case that the market value of the shares ought to prevail over the par value. They state that there is local authority for such approach, albeit in different circumstances in Lace Proprietary Mines Ltd¹⁸, where the court held that the taxpayer received 1000 000 shares as consideration and the shares had to be valued according to their market value. The Taxpayer, however, indicates that it is willing not to be dogmatic on the question of the existence of a concession granted by creditors under the preference share scheme although their inclination is toward the view that if the amount of the claims is reduced a concession has been granted. The fact that the creditor proceed to renounce their entitlement to lesser amount seems, to the The Taxpayer, to corroborate the view that a compromise or concession has taken place.

The keystone of the contention that preference share scheme possibly renders the provisions of s20(1)(a)(ii) wholly or partially inoperative rests on the following grounds¹⁹:

(a) No benefit has in fact been received by or accrued to the company in that although the form of liability has changed (ie, the creditor's claim into redeemable preference shares) the amount thereof (ie. the liability to redeem at the issue price which price is equal to the unpaid value of the creditors' claims) and the obligation to repay some has remained as before.

(b) It is general rule that a company cannot issue share on terms that it shall or may redeem then at an agreed future date as such redemption would amount to a purchase of its own shares, which is illegal. There is one exception to this general rule, however, the Companies Act makes provision for the issue of shares or out of profits for dividend. From a financial point of view redeemable preference shares may be regarded in the circumstance as hybrid form of shares and debentures incorporating features of both, though in law they are clearly treated as shares.

It has been emphasised in ITC²⁰ 1613 that any agreement or dispensation attributable to amending the capital structure relieving of the company by converting creditors' claims into permanent or long-term capital, must redound to its benefit. It is basically one which is undertaken to enable the company continue its normal operations. According to Wunsh J, the latter feature compels the conclusion that the company derived benefit from the arrangement and conversion of creditors claims to share capital. This grossly overstates the value of the future benefit against which the present set-off of assessed loss might be reduced. The new capital structure (redeemable preference shares) cannot be viewed as an asset of lasting value, rather, the restructuring confers on the company only ephemeral benefit of being to clear an existing hurdle and continue business. The problem is compounded by the inadequate emphasis given to the distribution of assets in ITC 1613 which is the detriment inherent in a preference share scheme is weighed against whatever positive aspects the compromise might have, it is difficult to view substantial and largely uncompensated expenditure necessary to meet current exigencies²¹.

In this regard it might well be said that the preference scheme resorted to by the taxpayer in ITC 1613 involved an agreement by the creditors to accept shares pro tanto in payment of their claims²². Although the shares were issued at an allotment price equal to the corresponding face value of their claims, it does not follow that they were worth their issue price. It is true that if the preference shareholders had undertaken action to enforce price payment of their claims, they

would not be paid in full.

Despite the presence of concession granted by creditors, in the present case, the assessed loss survived section 20(1)(a)(ii). The Commissioner's could not establish that the amount or value of the company's benefit was R18 807 524 or any of the quantified figures²³.

These flaws do not invalidate the preference share scheme, but do suggest that it is only a partial solution. These critical comments about preference share scheme must, however, be kept in perspective, if such a scheme is to be adopted.

4.3.4 The Excluded Creditor Scheme

One way of effectively reducing the amount of the benefit or concession, and particularly the cost of negotiating with large body of diverse and dispersed creditors is through Excluded Creditor scheme. The Excluded Creditor scheme is favourably adopted when a small number of creditors have in terms of value the greatest percentage of claims against the company²⁴. Compromise with its creditors ("the scheme creditor for a monetary consideration, as acquired from lent to the company by the proposer of the scheme. These claims creditors against the company are compromised and fully discharged in return for payment from the capital sum and in addition, on occasion from proceeds of sale of certain assets of the company); but the claims of the excluded creditors are dealt independently of the scheme by way of a separate agreement of cession between the creditor and the proposer of the scheme and to which the company is not a party. The claims of the excluded creditors are ceded to the proposer as against payment of monetary dividend which is usually the same as that paid to the company to the scheme creditor. As the face value of the ceded claims of all creditors against the company, the compromise with the scheme creditor is relatively small.

Consequently it is only by the relatively small amount in value of the compromise with the scheme creditors that assessed loss is reduced in terms s20(1)(a)(ii). No set-off against the assessed loss claims of the excluded creditor, to the proposer, such transaction falling outside the ambit of the scheme. The limitation of this scheme from income tax point of view is that not every company which is the target of a scheme satisfy the basic premise necessary for tax purposes pursuant to

s20(1)(a)(ii) (an indeed, for case of negotiation) that the excluded creditors should be few in number but constitute a significant majority in value.

4.3.5 The Development of a New Cape Scheme

The purport of the New Cape scheme may be conveniently summarised as follows:

(a) The objective of the New Cape is that the capital sum provided by the proposer (by way of a loan) top the company to enable it to compromise the claims of creditors for a monetary consideration, such claims upon sanction being deemed ceded to the proposer. The liability of the company on sanction (namely, its liability to proposer for the capital sum advanced and the ceded claims) are subordinated so that the company will, in the practical sense, be solvent, and in a position to continue trading as a going concern²⁵.

4.3.6 The Debenture Scheme

(a) the Debenture scheme satisfies the jurisdictional requirements of s311 in that it constitutes an arrangement between the company and its creditors.

(B) it is tax efficient from the point of view of preserving any assessed los of a company, subject of course to s103(2)

(c) the subordination of the debentures (and if necessary, the capital sum) resolves the issue of the reluctance of courts to discharge on insolvent company from winding-up²⁶.

It must respects the New Cape Scheme and the Debenture scheme appear to be tax efficient.

4.4 Summary

At present, the most significant limitation on the set-off of assesses loss is contained in section 20(1)(a)(ii). In order to derive maximum benefit of section 311 machinery, the proposer must ensure that the compromise benefit is kept at an absolute. In short, the proposer wishes go ahead with a standard scheme or any other schemes it more likely than not that the company's assessed loss or balance of assessed loss will remain largely intact. Barring Commissioner's counter attack in terms of 103(2), the acquirer will obtain considerable tax benefit.

1. The Taxpayer 'Company Schemes of Arrangement: Preserving the Assessed loss' Vol 38 (2) (Feb. 1989), pp 26
2. Jooste RJ 'Compromises and Assessed Losses' 26 Income Tax Reporter (1987) 323. Jooste RJ 'Schemes of Arrangement - A New Development' 28 Income Tax Reporter (1987) 7
3. *CIR v Stott* AD 252, 2 SATC 253, at 262
4. See *Matla Coal Ltd v CIR* 1987 (1) SA 108 (A), 48 SATC 223, 1987 Taxpayer 49, Emslie *et al* [85] Income Tax Cases & Materials, pp 168
5. *Lowenstein v COT* 1961 930 SA 543, (FC), 24 SATC 756
6. *De Beers Holdings (Pty) Ltd v CIR* 1986 (1) SA 8 (A), 47 SATC 229, 1986 Taxpayer 8
7. *Namex (Pty) Ltd v CIR* 1992 (2) SA 761 (C)
8. *Ex parte Kaplan & Others NNO: In re Robin Consolidated Industries Ltd* 1987 (3) SA 413 (W)
9. Jooste RJ 'Green light for the Standard Scheme?' (1994) 8 Tax Planning 125, pp 126
10. *Ex parte Millman & Others NNO: In re Multi-bou (Pty)Ltd* 1987 (4) SA 616 (C)
11. *Sackstein NO Bolstone (Free State) (Pty) Ltd (In Liquidation) & Others* 1988 (4) SA 550 (O)
12. See Finance Week August - September 1987 cited and discussed in Getz and Jooste 'Section 311 of the Companies Act: Preserving the Assessed Loss' supra at 65. The gravamen of the argument advanced by Finance Week as to the tax efficacy of the preference share scheme is to the effect that:
 - (a) There can be no doubt that one effect of the scheme is to reduce or extinguish the liabilities of the company concerned to its creditors. The question, however, is whether this results from a concession granted by or compromise made with these creditors.
 - (b) Creditors would receive in respect of their liabilities an amount in cash (say five cents) and balance by way of preference shares. Although creditors would effectively only receive (say five cent in the rand) this results from the renunciation of their rights to the preference shares in favour of the offeror, not as result of having entered into a compromise with the company.
 - (c) Section 20 does not only apply to compromises, however, but also to concession granted by creditors. There must be strong argument that the creditors are granting a concession to the company. It is argued that material factors which point in this direction are:
 - (i) The legal position of creditors is stronger than that of preference shareholders in that creditors rank in preference to shareholders on liquidation of the company. By accepting preference shares in place of the liabilities, the creditors may therefore be said to have granted a concession to the company as contemplated in s20.
 - (ii) Although the preference shares will be issued at a par value, this does not necessarily mean that they are in fact worth that value. Although the restructuring of the company may follow a scheme of the nature described may actually mean that the preference shares are worth their full value, this is certainly not automatic. In many cases it is unlikely that those preference shares could be redeemed immediately following the transaction at anything close to their par value. If

the value of the preference share is therefore less than their par value, there must be a strong argument that the creditors have granted a concession to the company.

13. Getz and Jooste *supra* at 65

14. The Taxpayer "Company Schemes of Arrangement: Preserving the Assessed Loss" Vol 38 (2) (Feb. 1989) referred to and discussed in Getz and Jooste *supra* at 66 - 67

15. *Grant v Federal Commissioner of Taxation* (1976) 7 Australian Tax Reporter cited in The Taxpayer *supra* 29

16. Per Jacobs in *Grant supra* in The Taxpayer, p29

17. Ibid.

18. *Lace Proprietary Mines Ltd v CIR* 1938 AD 267

19. Getz and Jooste *supra*, p 67 - 68

20. ITC 1613

21. ITC 1613 , at 196

22. ITC 1613 *supra*, 191

23. ITC 1613, *supra*, 196

24. Getz and Jooste *supra*, pp 67 - 70

25. For detailed discussion see Getz and Jooste *supra*, 73 - 74

26. Getz and Jooste *supra*, 77 - 78

CHAPTER 5

TRAFFICKING IN ASSESSED LOSSES OF COMPANIES

5.1 Introduction

Final provision dealing with allowability of assessed losses is contained in section 103(2). The rationale for the existence of this provision is neither far to seek nor difficult to comprehend. Section 103(2) is specifically directed at combatting schemes involving the utilisation of companies' assessed losses. It is settled law that section 103(2) should be construed so as to advance the remedy provided by the anti-trafficking provision and suppress the mischief which the section is directed. The basic lesson seem inescapable: trafficking in assessed losses of acquired companies can be costly exercise as ably demonstrated by the Conshu¹ case. It is clear, therefore, that the beneficial use of section 311 machinery is also constrained by the anti-avoidance provisions of section 103(2)

The fuller implications of invocation of section 103(2) will receive closer examination as well as the Conshu case.

5.2 Basic Provision of Section 103(2) provides that whenever

“the Commissioner is satisfied that any agreement affecting any company, as a direct or indirect result of which income has been received by or has accrued to that company during any year of assessment; has at any time before or after the commencement of the Income Tax Act 55 of 1946, been entered into or effected by any person solely or mainly for the purpose of utilizing any assessed loss incurred by the company, in order to avoid liability on the part of any tax, duty or levy on income, or to reduce the amount thereof, the set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed”. (my underlining).

The section further provides that:

“any decision of the commissioner under subsection- (2) ... shall be subject to objection and appeal, and whenever in proceedings relating thereto it is proved that the agreement or change in shareholding in question would result in the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act or an other law administered by the Commissioner, or in the reduction of the amount thereof, it shall be presumed, until the

contrary is proved -

(a)

(b) *in the case of any such agreement or change in shareholding, that it has been entered into or effected solely or mainly for the purpose of utilizing the assessed loss or balance of assessed loss in question in order to avoid or postpone such liability or to reduce the amount thereof.”*

It is to be noted that “ while subsection (4) of s103 places the onus on the taxpayer to prove that the agreement or change in the shareholding was not effected solely or mainly to avoid tax, it is submitted that where evidence is adduced which shows that there was some reason, equally weighty with that of tax avoidance, for entering the transaction, the assessed loss must not be denied to the taxpayer. By contrast, where section 103(2) is in issue, the taxpayer has the greater burden of proving that tax avoidance was an ancillary purpose and this is a much more difficult task. In nutshell the application of section 103(2) results in the disallowance of the set-off of any such assessed loss or balance of assessed loss ‘against any such income’².

5.3 Mechanics of Section 103(2)

5.3.1 Meaning of Solely or Mainly”

The major obstacle from the taxpayer’s point of view in rebutting any attack by the commissioner under this section would seem to be the onus of proving that the change in shareholding was not “solely or mainly” for the purpose of utilizing any assessed loss or balance of assessed loss. If the taxpayer can show that he had good reasons for entering into the agreement or effecting the change in shareholding, and the use of the assessed loss was a subsidiary reason or one that weighed equally with other reasons, the set-off of the assessed loss cannot be disallowed³.

The provisions of section 103(2) are also littered with expressions which cannot be construed with any measure of certainty. One example is the phrase “solely or mainly”. Little if any difficulty should be experienced in establishing whether activities have been undertaken or carried out “solely” for some particular purpose, but “mainly” implies a measure of degree on which opinions may frequently differ.

The meaning of “mainly” is not defined in the Act. The word is defined in the Oxford Dictionary as meaning “for the most part, chiefly “and chiefly” is defined as “above all, but not exclusive”.

These two definitions provide limited guidance as to the meaning of the word “mainly”, and unfortunately there are very few -reported cases in the application of s103(2). The test to be applied in determining the purpose for which the agreement is entered into would, after consideration of all the relevant facts, be a subjective one⁴. It must therefore be established what the parties to the agreement had in mind. The subjective test would seem to be aimed not only at determining the sole or main purpose of the agreement but also establish what assessed loss the parties had in mind at the time - what assessed loss was contemplated or envisaged in the agreement. For instance, the assessed loss in question can be identified in the relevant agreement itself or during the negotiations leading to the agreement.

Guidance can be obtained from ITC 983⁵. In this instance the appellant company had incurred large trading losses and eventually closed down its business of clothing manufacture.

Following a change in shareholding the business was recommenced on a cut, make and turn basis for the purchaser company at a fixed price per garment. The commissioner disallowed the set-off brought forward purporting to act in terms of s90(b). The purchaser company contended that it had acquired the appellant company as it was having difficulties in producing sufficient clothing to fulfill orders, and the appellant would provide an additional source of supply. The witness for the appellant admitted that the assessed loss was used as a bargaining factor by the sellers, and it did play some part in inducing the purchaser company to enter into agreement, but the main reason for doing so was to obtain a ready-made factory in which production could be commenced immediately

Furthermore, the purchaser company was able to show that subsequent to the acquisition of the appellant company, its own turnover and profit had increased and there was no evidence that it had diverted income to the appellant company. Watermeyer J (as he then was) was satisfied that although the avoidance or reductions of the tax was one of the purpose it was not the main purpose. A similar decision, which seems to be based on close reasoning, was by the Special Court in ITC⁶ 989. The court again looked to the results achieved by the

purchasing company and appellant company. The purchaser company had in fact diverted some of its profits to the appellant by selling by selling to the appellant, but at the same price as it charged to other merchants. Looked at from a group point of view, the profits of the appellant together with those of the purchaser would have achieved on its own. From this, the court held that the avoidance of liability for tax was not the sole or main purpose of change in shareholding, but rather there were good commercial reasons for the appellant being acquired by the purchaser.

In any dispute involving the application of s103(2), the full facts will have to be carefully examined. These facts will have to include the reputed purpose of the change in share holding the assets of the company, whether tangible/ intangible, as of the change-over date, and the subsequent activities of the company. The following observation has been made by EB Broomberg Tax Strategy 2ed (1983):

“whenever, in section 103(2) cases, the taxpayer failed to discharge the onus of proving a non-tax purpose for the transaction, there has often as not, been one tell-tale sign, namely, the purchase consideration payable by the taxpayer for the shares in the assessed loss company. If it appears that a taxpayer has paid more for the shares in the assessed loss company than they are worth, if regard is had exclusively to the net asset value of the company, or its income-earning potential, then the taxpayer would probably be well advised not to prosecute an appeal against a decision by the Commissioner to invoke the provisions of s103(2) unless he can show, some other way, the extra payment was not intended to pay for the tax benefit of the assessed loss”⁷.

5.3.2 Meaning of “any company”

The ambit of s103(2) would appear to be very wide on interpretation of the wording:

“any change in the share holding in any company”

In sense, therefore, the foundation for unrestrained application of s103(2) to “any agreement” affecting the company or “change in the shareholding” had already been laid. A stronger pointer as to the ambit of s103 is provided by Glen Anil Development Corporation Ltd,⁸ where Botha JA held that where a change in shareholding in a holding company has resulted in income being received by a subsidiary; section 103(2) can be invoked against the subsidiary.

Provided that there is no necessary link between the receipt of income by a company and the change in shareholding of the other company; s103(2) can be applied. It is a considered view that a change in shareholding of a company can only result in an application of the anti-trafficking provision to the income of another company if the two companies are related.

The word 'agreement' in s103(2) connotes a contract, that is to say, an agreement which is legally binds and enforceable between the parties. All this appears expressly recognised by Nicholas AJA in Ocean Manufacturing Ltd⁹. It is clear law that the words 'any agreement affecting any company' in s103(2) could not be restricted to agreements affecting the *control* of the company or affecting any person's right to participate in the profits or dividends of the company. There was nothing to suggest that the word 'any' was used in a limited sense.

In short, the court held that the section was applicable where there was no change in shareholding of the taxpayer company but an agreement was entered into whereby an existing business that was conducted by the shareholders of the company with an assessed loss was sold to the latter company in order to utilise its assessed loss for tax purpose.

Tax planning implications are clear: where shares are bought in or an agreement entered into with a company which has an assessed loss, it is important that the company retain pre-existing assets which continue to produce 'untainted' income¹⁰.

5.4 Discerning Tax Avoidance

In the wake of a change in shareholding, the new owners could direct the company along one or more of the following course of action:

- (I) Start new business in the company.
- (ii) Revive the existing business.
- (ii) Re-direct income to the company.
- (iv) Combination of the above.

The possible application of s103(2) to each of the above situations is discussed below.

5.4.1 Start new business

The application of s103(2) would appear to have been broaden by the decision in ITC 1123¹¹,

where it was held that the ant-trafficking provision can be applied not only to income diverted from another person to the company, but also to income produced by the company's own activities. The facts in that case were briefly that a taxpayer, R had acquired the entire share capital in the appellant company at a time when the company had no finance, no assets, no liabilities, no business and no loss. R immediately initiated a business in the company by arranging certain transactions with the companies under his control in return for commission. In addition, transactions were entered into with outside parties which produced profits from the buying and selling of money at interest and the discounting of bills. The appellant conceded that the set-off of the assessed loss against the income derived from the first type of transaction was correctly disallowed by the Secretary under s103(2), for it was income diverted to the company by R from the other companies. It was conceded, however, that the set-off should have been allowed in respect of the income derived from transactions with outside parties as this was income not diverted from another company.

Trollip J, the President of the Special Court, interpreted s103(2) as follows:

“that the section was intended to apply where income was diverted from another person to a company in order to avoid liability for tax on the part of the person is clear from its very language. But its wording is wide and there is no warrant for limiting its application to such cases. It refers in the first place to “income received by oraccrued to that company during any year of assessment ... That is wide enough to include income produced by its own activities in contradistinction to income diverted to it. Secondly, the section speaks of avoiding liability for tax (on the part of only other person, that shows that only diverted income but income produced by the company's own activities can fall within the ambit of the section if its other requirements are fulfilled”¹².

Trollip J further emphasised that the company had no business at the time of the change in shareholding. The company was merely a “shell” and only as a direct or indirect result of the change in share holding did the income accrue to the company. The appellant, on whom the onus rested, had failed to prove that the utilisation of the assessed loss was not his sole or main purpose in acquiring the shares and the appeal was accordingly dismissed. While accepting that the invocation of s103(2) had the effect of encompassing the acquisition of a

corporate loss shell with sizeable balance of assessed loss, it is submitted that the onus imposed on the purchasing company by the s103(4) can be successfully discharged. This is especially so in the case of a dormant company might have certain trade rights or well known trade name and the acquisition of these could be regarded as the main purpose.

5.4.2 Revive existing business

It is submitted that where a trading company with a large assessed loss, incurred because of the business being unsuccessful, is acquired and the new shareholders do nothing more than reorganise the existing business of the company, and return the company to a profitable situation, in appropriate circumstances may trigger the application of s 103(2).

This was nicely illustrated in Ocean Manufacturing Ltd¹³ where the court held that the section was applicable where there was no change in shareholding of the taxpayer company, but an agreement was entered into whereby an existing business that was conducted by the shareholders of the with an assessed loss was sold to the latter company in order to utilise its assessed loss for tax purpose. *In casu* two agreements had been concluded, the merger agreement concluded in October 1980 and the transfer agreement in July 1981. B had not been a party to the merger agreement providing for the reverse takeover of A, but only to the transfer agreement whereby C's business was transferred to B.

Similarly in ITC¹⁴ 1388 three appeals involving the same parties were all heard as one case. The first appeal involved the purchase of a company by the taxpayer and his wife. The company had an assessed loss that the commissioner refused to allow to be carried forward to be set-off against later profits, on the grounds that s103(2) applied. The taxpayer was able to produce sufficient evidence to convince the court that the transaction had not been entered into in order to avoid or postpone only liability to tax. In fact, when he bought the shares he was unaware that an assessed loss existed, since it had not been mentioned in the negotiations, purchase of the company's outstanding book debts. Only at the end of the negotiations was it suggested that, since the company enjoyed some goodwill in the area in which it was trading, than only the book debts.

The taxpayer argued that s103(2) could not apply since the change in share holding did not result in a diversion of funds into the company from outside, and its increased profitability was entirely due his and his wife's efforts. Although he succeeded in his appeal, this argument did not find favour with the court. It held that s103(2) did not only apply when income is diverted into the company after a change in share holding brings about revitalizing and resuscitation of the company. In adopting this approach Eksteen J followed Trollip in ITC 1123, in which an individual acquired control of a company with a large balance of assessed loss he diverted income from other sources to this company and at the time caused the company to commence earning afresh on its own behalf. While counsel for the company was prepared to concede that the diverted income was wholly taxable, he argued that the assessed loss ought to be set-off against the remaining income. Trollip J, however, was of the firm opinion that s103(2) was drawn broadly enough to catch both types of income. He said:

“Otherwise, to take a clean example, the income from a new and unrelated types of business started by the new shareholders of the company, that having acquired the shares solely or mainly for tax avoidance, would escape liability for tax on such income by its being set-off against the assessed loss produced by the discontinued business of the company under erstwhile shareholders”¹⁵.

The second appeal in ITC 1388 was conducted along similar lines to the first. Again the taxpayer and his wife had brought the company in order to obtain its book debts. In this transaction, however, the company had not been trading for in a number of years, and balance sheets and profits and loss accounts were available showing the existence and extent of the assessed loss. The taxpayer was unable to convince the court that the transaction did not all within the ambit of s103(2), and his appeal failed.

Eksteen J extracted the main features of s103(2) stating that any assessed loss must be disallowed by the commissioner if he is satisfied:

“(a) that any agreement has been concluded affecting any company, or that a change in share holding of company has taken place;

(b) that as direct/indirect result thereof income has been received by or accrued to that company during the year of assessment, and change in shareholding effected solely or mainly

for the purpose of utilising any assessed loss incurred by the company in order to avoid liability on the part of the company or any other person for the payment of income tax”¹⁶.

Although most of the cases referred here were decided in against the Commissioner, there have been other cases in which the taxpayer was unable to show that the utilization of an assessed loss was not its sole or main purpose in effecting an agreement or change in share holding. It follows that the facts of each case have to be carefully examined in order to ascertain whether s103(2) can be successfully applied to disallow the set-off of an assessed loss.

5.4.3 Re-direct income to the company

This type of situation would at first appear to fall squarely into the ambit of s103(2). However, situations could arise where although income has been re-directed to the company, it could have been arranged for a good commercial reason unrelated to tax avoidance. In such a situation the company could successfully discharge the onus of proving that the change in shareholding was not “solely or mainly” for the purpose of utilizing the assessed loss.

The Special Court in ITC¹⁷ 1347 dealt with the acquisition of the shares in a clothing manufacturing concern with an assessed loss by a company in same line of business. By way of background after experiencing financial difficulties the company was placed in provisional liquidation until an offer of compromise sanctioned in terms of section 311 of the Companies Act 61 of 1973. Thereafter the company was discharged from provisional liquidation. The Commissioner acting in terms of s103(2) disallowed the balance of assessed loss to be carried forward from 1975 on the ground that the shares of the taxpayer had been acquired solely or mainly for the purpose of using the assessed loss for the set-off against income that might accrue to the taxpayer.

Smallberger J (as he then was) found that the shares were not acquired solely or mainly for the purpose of using the assessed loss. So far as material, the taxpayer had assets of value including trade marks and import permits. There were practical reasons unconnected with assessed loss fro acquiring the shares of the taxpayer¹⁸. As evident from the facts the head

been no diversion of income from B to the taxpayer despite the fact that subsequently, due to economic factors, the taxpayer's production was moved from D to C (where B's manufacturing plant was situated) and the taxpayer became a distributor of products manufactured by B using the taxpayer's plant machinery (for which rental was derived by the taxpayer).

5.4.4 Combination of the above

A combination of the aforementioned factors will surely trigger the application of section 103(2) unless there is compelling evidence to the contrary.

5.5 **Trafficking in Assessed Losses of Companies After Conshu**

Can companies assessed losses still be utilized? "That is the question now being asked in the offices of accountant and lawyers and chambers of many of the advocates at the Bar since the pronouncement of the Appellate Division in deciding Conshu. This decision was to the effect the commissioner is not limited to invoke s103(2) only in respect of the tax year in which the relevant agreement is concluded or the change in share holding effected: he must wait for an attempted set-off by the taxpayer under s20 against tainted income.

The facts of the case are important. The taxpayer (C) suffered an assessed loss of R3.3 million during its tax year ending on 30 June 1984. After taking into account its accumulated assessed loss brought forward from its previous tax year, the Commissioner determined its new balance of assessed loss at approximately R5,9 million. During the tax year its trading results deteriorated further. Pressure from bankers forced it to take drastic step towards the end of that year. They involved, *inter alia*, a change in its shareholding, the disposal of the bulk of its business, and the acquisition, on the last day of the tax year, of all trading assets and liabilities of another company. In its return for the 1985 tax year reflected the effect of the disposal of its business and the acquisition of the new trading assets and liabilities. The assessed loss for 1985 was added to the accumulated loss of R5,9 million brought forward from 1984. The assessed loss at the end of 1985 carried forward to the 1986 tax year came to some R9,9 million. The changes made to its business during 1985 produced taxable income of about R6,5 million for the 1986 tax year. C sought to utilize s20 during 1986 by setting off the

assessed loss of R9 million brought forward from 1985 against taxable income of R6,5 million for 1986. The Commissioner initially allowed this set-off. But he invoked s103(2) and stated that he was satisfied that the transaction whereby C had acquired the new trading assets had been entered solely or mainly to postpone its liability for the payment of income tax. He accordingly ruled that C was not allowed to utilize the accumulated assessed loss brought forward from 1985 against the income derived during 1986 from the assets acquired during 1985¹⁹.

Swart G J states as follows in regard to the minority reasoning as to the moment of application of section 103(2):

The conflicting majority and minority views in *Coshu* lead to entirely different results. The absence of tainted income (that, income received or accrued as a direct or indirect result of the relevant agreement or change in shareholding) during the tax year in which the agreement is concluded and takes effect will, in the minority view, place the taxpayer beyond the reach of s 103(2), as this provision can be invoked only in that tax year and in no other. But the minority expressly refrained from considering the position should an agreement be concluded in one year but only take effect in a later year (*supra* at 615n). Section 103(2) can, according to the minority view be applied only to the assessed loss for the year before the one in which the agreement is concluded, since that is the assessed loss at the time when s 103(2) should be invoked²⁰.

The implications of the majority view for the schemes involving the utilisation of corporate loss shell's accumulated assessed loss are significant: Section 103 is to be invoked in respect of the tax year in which the company tries to set-off assessed loss against tainted income for the first time, irrespective of whether the relevant agreement or change in shareholding was effected in that or an earlier year. It is submitted, correctly, that the majority approach as to the moment of application of the anti- trafficking provision is in complete harmony with the intention of Parliament as inferring from the nature of the remedy contained in section 103(2). In reaching a decision adverse to the taxpayer, Harms JA concluded that because the Commissioner could not have done applied s103(2) to the 1985 year entailed that the Commissioner is precluded from doing so in respect of 1986 would be destructive of the purpose of the provision.²¹ The court found that, the Special Court had been correct in finding

that it was competent for the Commissioner to apply s 103(2) for the first time in relation to the 1986 tax year.

More helpful, in my opinion, is the submission by TS Emslie (Some Thoughts on Conshu): “It seems that a good case can be made for the need to enact amending legislation to clarify the interpretation of both s 103(2) and s 20(1), and possibly also s 22(1) and (2) of the Act in the light of the difference of judicial opinion in Conshu. Alternatively, a practice to be adopted in the face of conflicting judgements in Conshu would seem to be called for”²².

It is the submission of the writer that, the decision in Conshu may be said to constitute a further deterrent to trafficking in assessed losses of companies.

5.6 Summary

The major watershed highlighted by the foregoing discussion is between diametrically opposed judicial views expressed in Conshu as to tax year in respect of which the Commissioner is entitled to invoke section 103(2). It is now clear law that the Commissioner is empowered to invoke the anti-avoidance provisions contained in section 103(2) in a tax year subsequent to that which the relevant agreement was concluded or the change in shareholding occurred.

The anti-trafficking provisions would appear to have little effect on the utilisation of acquired companies’ accumulated assessed losses to generate tax sheltered income. The re-directing of income from one company to another remains endemic in practice and particularly so in group situations where there are many subsidiaries. It would seem that provided that there is a commercial reason unconnected to tax avoidance, for the purchase of a company with an assessed loss, section 103(2) could not be applied.

The anti-trafficking provisions contained in sections 103(2) form an important arsenal in the Commissioner’s litigation strategy and crackdown against tax avoidance schemes. Equally important, the Commissioner’s attack on such schemes is not limited to the provisions of section 103(2), but could in appropriate circumstances resort the main anti-avoidance provision contained in section 103(1).

1. *Conshu (Pty) Ltd v CIR* 1994 (4) SA 603 (A)
2. Stewart D M "The Prohibition of Tax Avoidance: An Evaluation of Section 103(2) of the South African Income Tax Act 58 Of 1962' (1970) 3 CILSA 168, pp 191
3. Silke J Tax Reporter 1991 'Assessed Loss of Companies' (30), pp 49
4. Swart GJ "The Utilization of Assessed Losses by Companies - Reappraisal after *Conshu (Pty) Ltd v Commissioner for Inland Revenue*" (1996) 8 SA Merc LJ 110, p135. See *Glen Anil Development Corporation Ltd v SIR* 1975 (4) 715 (A) at 730H and 734 A-C, *Ocean Manufacturing Ltd* 1990 (3) SA 610 (A) at 613 D-F, 375 SATC 319, 1990 Taxpayer 147,
5. ITC 983 25 SATC 55, 1963 Taxpayer 106
6. ITC 989 25 SATC 122, 1963 Taxpayer 116
7. Broomberg EB Tax Strategy 2ed (1983), pp 217
8. *Glen Anil Development Corporation Ltd v SIR* 1975 (4) SA 715 (A), 37 SATC 319, 1975 Taxpayer 226
9. *CIR v Ocean Manufacturing Ltd* 1990 (3) SA 610 (A), 52 SATC 151, 1990 Taxpayer 147, Emslie, Davis and Hutton [243] Income Tax Cases & Materials, pp 864
10. Broomberg EB Tax Strategy 2ed (1983), pp 219
11. ITC 1123, 31 SATC 48, 1969 Taxpayer 208
12. ITC 1123 *supra*, in [240] Income Tax Cases & Materials, pp 851
13. *CIR v Ocean Manufacturing Ltd supra*
14. ITC 1388 (1983) 46 SATC 126
15. Per Trollip J in ITC 1123 *supra*, at 52 quoted with approval in ITC 1388
16. Per Eksteen J in ITC 1388 *supra*, at 152
17. ITC 1347, 44 SATC 33, 1986 Taxpayer 89
18. ITC 1347 *supra* in [242] Income Tax Cases & Materials, pp 860
19. *Conshu (Pty) Ltd supra* headnote at 603 D-G, See Swart GJ *supra* pp 119 - 120
20. Swart GJ *supra* pp 133 - 134
21. *Conshu (Pty) Ltd supra* at 613G/H
22. TS Emslie The Taxpayer "Some Thoughts on Conshu" (unpublished), pp 8

CHAPTER 6

SECTION 311 SCHEMES USEFUL TAX DEVICE DESPITE REVENUE CRACKDOWN

6.1 An Overview

The overall thrust of this paper should be now clear. The *leit motif* behind s 311 schemes of arrangements and compromise is the assessed loss carry forwards. And there are innovative techniques to preserve assessed loss, thereby ensuring beneficial use of s311 machinery.

Assessed loss is a unique asset for tax planning purposes, because its value greatly appreciates as it generates tax-sheltered income in subsequent years until it is fully exhausted. The tax-sheltered income represents a kind of incentive and an assessed loss an alluring commodity. This quality can be a two-edged sword, depending on how s 311 scheme is structured and the likelihood of Inland Revenue's counter-attack.

6.2 Section 311 Schemes can be a Tax-efficient too, but there are still points to watch

Two of the more serious pitfalls for the utilization of company's assessed losses are:

Sections 20(1) and 20(1)(a)(ii) which set forth the package elements that must be complied with for the allowability of assessed loss. First, the taxpayer's activities must constitute carrying on trade as envisaged by s20(1), in order to avoid sterilization of assessed loss. Also, the trade need not be carried throughout the year. A company which carries on no trade at all during a tax year forfeits any assessed loss brought forward from a prior year, as the continuity implied by s20(1) is irretrievably broken.

The other limb of s20, is s20(1)(a)(ii), the taxpayer has to establish the absence of one/more of the following:

1. A concession granted by or compromise with the company's creditors
2. The receipt by or accrual to the company of a benefit from para 1.

The application of this provision could result in the obliteration of company's assessed loss. Significantly, tax planning objectives of s311 schemes are directed at mitigating the application of s20(1)(a)(ii).

Section 103(2) is the last basic weapon in the arsenal of the commissioner seeking to halt trafficking in assessed losses of companies. The application of s103(2) will result in the disallowance of the attempted set-off assessed loss against any year of assessment as a direct or indirect result of the relevant agreement or change in shareholding (“tainted income”). The dominant view in Conshu now taken as settled law, that the Commissioner is not limited to invoke s103(2) only in respect of the tax year in which the relevant agreement is concluded or the change in shareholding is effected: he must wait for an attempted set-off by the taxpayer under s20 against tainted income. Consequently, s103(2) therefore is to be invoked in respect of the tax year in which the company tries to set-off an assessed loss against tainted income for the first time, irrespective of whether the relevant agreement or change in shareholding was effected at an earlier year.

Trafficking in assessed losses is still lawful, still profitable, and, if anything more attractive now than it was. The severe limitations now applicable to Conshu as a result of the Appellate Divisions conflicting judgements -all of which have highlighted the need to enact amending legislation to clarify the interpretation of both s103(2), and possibly also s22(1) and (2) of the Act. Avoiders and planners will no doubt wish to resuscitate their practices as soon as possible.

6.3 Summary and concluding remarks

It is frequently stated that the system of taxation in South Africa is harsh and inflexible while this may be true on a strict reading of the law, it is hoped that the foregoing will serve to demonstrate that, in practice, the impact of direct taxation can be and frequently is mitigated by reliefs and concessions. In particular, if a sufficiently large and intact balance of asses loss is concerned, and the acquirer consider an insolvent company to be worthy of consideration, he will effect s311 compromise with creditors. With this in mind, it becomes clear that assessed loss remain the driving force behind schemes of arrangement and compromise carried out in terms of s 311 of the Companies Act.

Because the invocation of section 20 in conjunction with s 103(2) will result in the forfeiture or sterilization of assessed losses, the best defense is a constant and careful self-review to ensure that the scheme is tax efficient.

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