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Income Tax – Sale of a going concern: Assumed Contingent Liabilities

Clarification versus legislative reforms

by

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ABSTRACT

The income tax consequences that flow from the assumption of contingent liabilities as part of the sale of a going concern is a contentious matter that continues to frustrate sellers and purchasers.

The challenges faced by sellers and purchasers include inherent mismatches between the objects of accounting practice and that of income tax legislation; inconsistent policy formulation by National Treasury (Treasury) and the South African Revenue Service (SARS), and income tax legislation and case law that do not adequately recognise the economic effect of these transactions for sellers and purchasers. These, and other, challenges are highlighted and unpacked in this study by evaluating accounting standards, the *Income Tax Act* 58 of 1962 (ITA), case law and publications by SARS.

In recent years there have been increasing calls for Treasury and Parliament to intervene by means of legislative reforms and for SARS to issue guidelines, in order to provide clarity regarding the income tax consequences for sellers and purchasers.

New provisions and amendments to the ITA were proposed in the *Draft Taxation Laws Amendment Bill* of 2011 (draft Bill). The proposed legislative reforms were however withdrawn before the *Taxation Laws Amendment Bill* of 2011 was introduced in Parliament.

Interpretation Note 94: Contingent Liabilities Assumed in the Acquisition of a Going Concern (IN94) was published by SARS during the latter part of 2016, with the aim of setting out principles which can serve as an interpretative guide for the determination of the income tax consequences for sellers and purchasers. This study investigates whether IN94 adequately addresses the challenges highlighted in this dissertation.

The Davis Tax Committee, in its *Report on the Efficiency of South Africa's Corporate Income Tax System,* states that while SARS has attempted to address some of the shortcomings in respect of the taxation of contingent liabilities through interpretation notes and rulings, this is unsatisfactory as it is the legislation which requires amendment in order to address the shortcomings. In the final part of this study, the legislative reforms proposed in the draft Bill

are evaluated, and the case is made for the reconsideration of comprehensive legislative reforms in order to create more certainty for sellers and purchasers.

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ABBREVIATIONS AND TERMINOLOGY

BPR	Binding Private Ruling
CGT	Capital Gains Tax
CIR	Commissioner for Inland Revenue
Corporate Rules	Sections 41 to 47 of the ITA
CSARS	Commissioner, South African Revenue Service
Davis Tax Committee and DTC	the South African Tax Review Committee chaired by Judge Dennis Davis
Eighth Schedule	the Eighth Schedule to the ITA
General Deduction Formula	Collectively the requirements as set out in section 11(a) read with sections 23(f) and 23(g) of the ITA
Going concern	All or a part of a business which is capable of separate operation and constitutes an income-earning activity in its own right at the date of sale
IAS	International Accounting Standards
IAS 37	IAS 37 – Provisions, Contingent Liabilities and Contingent Assets
IFRS	International Financial Reporting Standards
IFRS 3	IFRS 3 – Business Combinations

IN94	Interpretation Note 94: Contingent Liabilities Assumed in the Acquisition of a Going Concern
ITA	*Income Tax Act* 58 of 1962, as amended
ITC	Income Tax Case
KBI	Kommissaris van Binnelandse Inkomste
LRA	*Labour Relations Act* 66 of 1995, as amended
Parliament	the Parliament of South Africa
SARS	the South African Revenue Service
SIR	Secretary for Inland Revenue
South Africa	the Republic of South Africa
Treasury	the National Treasury of South Africa
TAA	*Tax Administration Act* 28 of 2011, as amended

All references to the terms "gross income" and "income" shall be to "gross income" and "income" as defined in section 1(1) of the ITA unless otherwise specified.

All references to "proceeds" shall be to proceeds as determined in terms of paragraph 35 of the Eighth Schedule unless otherwise specified.

1. INTRODUCTION

1.1 Background and rationale for the study

The income tax consequences that flow from the assumption of contingent liabilities as part of the sale of a going concern is a contentious matter that continues to frustrate sellers and purchasers.

In many instances the net asset value of a business, i.e. assets less the liabilities, will dictate the purchase price of the business (*Ackermans Ltd v CSARS*, 2011: para [10]). The financial reports of a company will generally be used in the determination of the purchase price of a sale agreement (Van Coller, 2011: 455). In terms of the *Companies Act* 71 of 2008, certain companies are obligated to satisfy financial reporting standards such as the International Financial Reporting Standards (IFRS) as to form and content when preparing their financial statements (Cassim et al., 2012: 598).

With the preparation of financial statements being based on financial reporting standards, the basis for the calculations, definitions and objects of accounting profits will differ from that of income tax for the purpose of determining taxable income (Van Coller, 2011: 459). It has been stated that accounting methods are irrelevant for the purpose of income tax as it is not the "profit" or "gain" that is taxed, but "taxable income", which is an artificial concept (*Pyott v CIR*, 1945: 126 – 127).

There are inherent mismatches between the objects of accounting practice and that of income tax that are not currently addressed in the ITA, and which are difficult to reconcile where contingent liabilities are assumed as part of the sale of a going concern (Van Coller, 2011: 460 – 461). For example, contingent liabilities may be relevant in the determination of the value of a going concern for the purpose of the sale agreement, but will not necessarily be relevant in the determination of the value of the discrete assets comprising the going concern for accounting and income tax purposes.

In recent years, and following the unanimous judgment in *Ackermans Ltd v CSARS* (Ackermans case) by the Supreme Court of Appeal, there have been increasing calls for the National Treasury of South Africa (Treasury) and the Parliament of South Africa

(Parliament) to formulate and adopt legislative reforms and for the South African Revenue Service (SARS) to provide guidance regarding the income tax treatment of assumed contingent liabilities.

To date the Ackermans case is the only authoritative reported judgment on the matter. The Ackermans case is, however, only representative of one manner in which a sale of a business as a going concern and the assumption of contingent liabilities can be structured.

Germishuys & McGregor commented in their critique of the Ackermans judgment that:

> *"The Ackermans case was decided on the law as it stood at the time. The fact that economic rationality and good business sense supported the taxpayer's claim was irrelevant, because the ITA did not support its claim"* (Germishuys & McGregor, 2014: 447).

Treasury undertook to formulate a set of rules to ensure that the transfer of contingent liabilities as part of the acquisition of a going concern does not give rise to "double deductions" or "double inclusions" (Treasury, 2011: 191). In the case of the corporate reorganisation rules (Corporate Rules) of the ITA,[1] Treasury proposed that contingent liabilities be completely transferred from sellers to purchasers (Treasury, 2011: 191).

Certain new provisions and amendments to the ITA were proposed in the *Draft Taxation Laws Amendment Bill of 2011* (draft Bill). The proposed legislative reforms were however withdrawn before the *Taxation Laws Amendment Bill* of 2011 was introduced in Parliament; and apparently due to the unresolved debate regarding who should be entitled to a deduction in respect of the assumed contingent liabilities, i.e. the purchaser or the seller (Treasury and SARS, 2011: 14). Treasury and SARS in their *Response Document* to Parliament's Standing Committee on Finance indicated that a general binding ruling or an interpretation note would be released to clarify the tax treatment of assumed contingent liabilities (Treasury and SARS, 2011: 14).

[1] Sections 41 to 47 of the ITA.

SARS released a discussion paper titled: *Discussion Paper on the Tax Implications for the Seller and Purchaser in Relation to the Assumption of Contingent Liabilities in Part Settlement of the Purchase Price of Assets Acquired as Part of a Going Concern* on 4 December 2013. The Discussion Paper was followed by a draft interpretation note on 31 December 2015. *Interpretation Note 94: Contingent Liabilities Assumed in the Acquisition of a Going Concern* (IN94) was finalised and published on 19 December 2016.

Drawing from legislation and local and foreign case law, SARS attempted to distil in IN94 principles which may serve as an interpretative guide for the determination of the income tax consequences for sellers and purchasers when the purchase price of assets acquired as part of going concern is settled, or partly settled, by the assumption of contingent liabilities (SARS, 2016a: 2).

While lobbying from industry has resulted in various attempts by Treasury, Parliament and SARS to address the abovementioned concerns, it appears that the results of Treasury and SARS's efforts might be limited, inconsequential and ineffective. Given the protracted nature of the processes adopted by Treasury and SARS the question has arisen whether IN94 is an effective measure to address the uncertainties regarding the income tax treatment of assumed contingent liabilities. It is considered that the case for legislative reforms should be further investigated.

The above view is supported by the Davis Tax Committee, which held in its *Report on the Efficiency of South Africa's Corporate Income Tax System*, that while SARS has attempted to address some of the abovementioned shortcomings in respect of the taxation of contingent liabilities through interpretation notes and rulings, this is unsatisfactory as it is the legislation which requires amendment in order to address the shortcomings (Davis Tax Committee, 2018: 56).

The aim of finally resolving this matter should arguably be to achieve greater certainty for sellers and purchasers. It is also in the interest of Treasury and SARS to address this matter from a tax administration and collection perspective. Time and resources spent on disputes such as who is entitled to claim an income tax deduction or allowance can effectively be avoided in future should appropriate measures be adopted.

1.2 Research objectives and approach

This study will consider the merits and demerits of the alternative interventions proposed by Treasury and SARS. Ultimately this study will address and attempt to answer the main question, which is whether the uncertainties regarding the taxation of contingent liabilities assumed as part of the acquisition of a going concern can be resolved by interpretive tools, such as Interpretation Notes and Advance Rulings published by SARS, or whether comprehensive legislative reforms are required.

This study will comprise the following chapters:

(i) **Chapter 2**: An analysis of the differences between contingent liabilities for the purposes of income tax and financial accounting.

(ii) **Chapter 3**: General income tax considerations in respect of the sale of a going concern.

(iii) **Chapter 4**: A review of relevant case law and advance rulings published by SARS to highlight uncertainties regarding the taxation of assumed contingent liabilities from the perspective of sellers and purchasers.

(iv) **Chapter 5**: A critical analysis of IN94.

(v) **Chapter 6**: An analysis of the desirability of legislative reforms. The focus of this chapter will be an analysis of the withdrawn legislative amendments mooted in the draft Bill and the possible introduction of a system of group taxation.

(vi) **Chapter 7**: Sets out the conclusion of this study and recommendations for further studies.

1.3 Research methodology

The doctrinal investigation research method will be employed in conducting this study which can be described as follows:

> *"Doctrinal research is described as the traditional or "black letter law" approach and is typified by the systematic process of identifying, analysing, organising and synthesising statutes, judicial decisions and commentary. It is typically a library-based undertaking, focused on reading and conducting intensive, scholarly analysis."* (McKerchar, 2008:15).

In addressing the research questions, the primary sources will include the ITA and South African case law, Interpretation Notes and Binding Private Rulings published by SARS, financial accounting standards, etc. Secondary sources will include foreign case law and commentary by South African writers. This is required to lay the conceptual foundation for the study and to unpack the research question.

1.4 Limitations on the scope of the study

The study will not propose specific interventions or policies to be adopted by Treasury, Parliament or SARS. The study will only focus on companies incorporated, established or formed in South Africa and which companies are tax resident in South Africa.

2. ANALYSIS OF THE DIFFERENCES BETWEEN CONTINGENT LIABILITIES FOR THE PURPOSES OF INCOME TAX AND FINANCIAL ACCOUNTING

2.1 General deduction formula

To set the scene for the chapters that follow, this study necessitates an overview of sections 11(a), 23(f) and 23(g) of the ITA (commonly referred to as the General Deduction Formula), and how they relate to contingent liabilities.

Section 11(a) of the ITA provides that:

> *"**11. General deductions allowed in determination of taxable income.** – For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived-*
> *(a) expenditure and losses actually incurred in the production of the income, provided such expenditure and losses are not of a capital nature;"* [underlined own emphasis].

From the seller and the purchaser's perspective all of the following requirements must be met for an amount to be deductible:

(a) Expenditure and losses (section 11(a) of the ITA)

The amount must constitute either "expenditure" or a "loss".

One is required to consider the ordinary meaning of the terms "expenditure" and "losses" as both terms are not defined in the ITA.

> Expenditure (noun) – *"The action of spending funds; An amount of money spent; The use of energy, time, or other resources."* (English Oxford Living Dictionaries, 2019: "Expenditure").

In *CSARS v Labat Africa Ltd,* Harms AP held that:

> *"The term 'expenditure' is not defined in the Act, and since it is an ordinary English word, this meaning must be attached to it unless context indicates otherwise. Its ordinary meaning refers to the action of spending funds; disbursement or consumption; and hence the amount of money spent. The Afrikaans text, in using the term 'onkoste', endorses this reading. In the context of the Act it would also include the disbursement of other assets with a monetary value. <u>Expenditure, accordingly, requires a diminution (even if only temporary) or at the very least movement of assets of the person who expends. This does not mean that the taxpayer will, at the end of the day, be poorer because the value of the counter performance may be the same or even more than the value expended.</u>"* [underlined own emphasis] (*CSARS v Labat Africa Ltd*, 2013: para [12]).

The listed passage implies that "expenditure" refers to either the spending of money, the use of some other resources or a combination of the two. The term "expenditure" is therefore not restricted to the spending of an amount in money.

> Loss (noun) – *"The fact or process of losing something or someone; An amount of money lost by a business or organization; The feeling of grief after losing someone or something of value; A person who or thing that is badly missed when lost."* (English Oxford Living Dictionaries, 2019: "Loss").

Regarding the distinction between "expenditure" and "loss(es)" Watermeyer CJ, in *Joffe & Co (Pty) Ltd v CIR*, held that:

> *"The word "loss" has several meanings and its meaning in sec 11(2)(a) is somewhat obscure. In relation to trading operations the word is sometimes used to signify a deprivation suffered by the loser, usually an involuntary deprivation, whereas expenditure usually means a voluntary payment of money."* (*Joffe & Co (Pty) Ltd v CIR,* 1946: 360).

(b) Actually incurred (section 11(a) of the ITA)

It is trite that for expenditure to be deductible in a particular year of assessment, that expenditure must have been actually incurred in that year of assessment. In *Caltex Oil (SA) Ltd v SIR*, Botha JA confirmed the following:

> *"It is clear from these provisions that income tax is assessed on an annual basis in respect of the taxable income received by or accrued to any person during the period of assessment, and determined in accordance with the provisions of the Act. In determining the taxable income of a person carrying on any trade in any year of assessment there is, in terms of s 11(a), deductible from such person's income the expenditure actually incurred by him in the production of the income during that year of assessment. (Sub-Nigel Ltd v Commissioner for Inland Revenue 1948 (4) SA 580 (A) at 589.) It is only at the end of the year of assessment that it is possible, and then it is imperative, to determine the amounts received or accrued on the one hand and the expenditure actually incurred on the other during the year of assessment. (Cf Port Elizabeth Electric Tramway Co Ltd v Commissioner for Inland Revenue 1936 CPD 241 at 244, and Commissioner for Inland Revenue v Delfos 1933 AD 242 at 257.)* (*Caltex Oil (SA) Ltd v SIR*, 1975: 674A to 674D).

Regarding what is meant by "actually incurred", Watermeyer AJP, in *Port Elizabeth Electric Tramway Company Ltd v CIR*, held that the phrase "actually incurred" does not equate to "necessarily incurred".

> *"The use of the word "actually" as contrasted with the word "necessarily" may widen the field of deductible expenditure. For instance, one man may conduct his business inefficiently or extravagantly, actually incurring expenses which another man does not incur; such expenses therefore are not "necessary" but they are actually incurred and therefore deductible."* (*Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936: 15).

It has also been confirmed, and on numerous occasions, that the incurral of expenditure does not require that expenditure must have been paid during the relevant year of assessment:

> *The expression "expenditure actually incurred" in s 11(a) does not mean expenditure actually paid during the year of assessment, but means all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not. (Port Elizabeth Electric Tramway Co v Commissioner for Inland Revenue (supra at 244) and ITC 542 (13 SATC 116 at 118)). It is in the tax year in which the liability for the expenditure is incurred, and not in the tax year in which it is actually paid (if paid in a subsequent year), that the expenditure is actually incurred for the purposes of s 11(a)."* (*Caltex Oil (SA) Ltd v SIR*, 1975: 674D to 674E).

More recently, Harms AP in *CSARS v Labat Africa Ltd* held that a distinction must be drawn between the following:

> *"The terms 'obligation' or 'liability' and 'expenditure' are not synonyms. This is apparent from what was said by Botha JA in Caltex Oil (SA) Ltd v Secretary for Inland Revenue 1975 (1) SA 665 (A) at 674D – E, namely that the expression 'any expenditure actually incurred' means 'all expenditure for which a liability has been incurred during the year, whether the liability has been discharged during that year or not'. (Emphasis added.) In other words, the liability or obligation must be discharged by means of expenditure — timing is not the question."* (*CSARS v Labat Africa Ltd*, 2013: para [8]).

At this juncture it also must be noted that it is only expenditure for which an unconditional liability has been incurred that will meet the requirements of section 11(a) of the ITA (*Edgars Stores Ltd v CIR*, 1988: 889A to 889C). Contingent liabilities and relevant case law are addressed in more detail below.

(c) In the production of income (sections 11(a) and 23(f) of the ITA)

Expenditure must meet the dual test under sections 11(a) and 23(f) of the ITA. In other words, for a deduction to be allowed it must be permitted under section 11(a) and not be disqualified under section 23(f) of the ITA.

Section 23(f) of the ITA prohibits the deduction of expenses incurred in respect of amounts received or accrued which do not constitute income in the determination of taxable income. In principle, similar considerations will govern the deductibility under both provisions (De Koker & Williams, 2018: §7.8).

The term "income" is defined in section 1(1) of the ITA as the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax.

The general principles are well entrenched, and have been distilled in the following judgments:

In *Port Elizabeth Tramways Company Ltd v CIR*, Watermeyer AJP held that:

> *"The purpose of the act entailing expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible."* (*Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936: 16).
>
> and
>
> *"The other question is, what attendant expenses can be deducted? How closely must they be linked to the business operation? Here, in my opinion, all expenses attached to the performance of a business operation bona fide performed for the purpose of earning income are deductible whether such expenses are necessary for its performance or attached to it by chance or are bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that they may be regarded as part of the cost of performing it."* (*Port Elizabeth Electric Tramway Company Ltd v CIR*, 1936: 17 – 18).

Schreiner JA, in *CIR v Genn & Co (Pty) Ltd*, confirmed the above, and held that:

> *"If I am right in understanding the words 'they may be regarded' as connoting that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation this passage seems to state the approach to such questions correctly. Whether the closeness of the connection would properly, naturally or reasonably lead to such treatment of the expenses must remain dependent on the Court's view of the circumstances of the case before it."* (*CIR v Genn & Co (Pty) Ltd*, 1955: 299B – 299C).
>
> and
>
> *"In deciding how the expenditure should properly be regarded the Court clearly has to assess the closeness of the connection between the G expenditure and the income earning operations, having regard both to the purpose of the expenditure and to what it actually effects."* (*CIR v Genn & Co (Pty) Ltd*, 1955: 299F – 299G).

In *Sub-Nigel Ltd v CIR*, Centlivres JA held that:

> *"It seems to me clear on the authorities that the Court is not concerned whether a particular item of expenditure produced any part of the income: what it is concerned with is whether that item of expenditure was incurred for the purpose of earning income. The reason why the Legislature used the definite article 'the' before 'income' in sec. 11 (2) (a) is probably because it had previously used it in the immediately preceding sub-section."* (*Sub-Nigel Ltd v CIR*, 1948: 592).

The conclusion from the *Sub-Nigel Ltd v CIR* judgment is that it is not necessary that it be proved that expenditure had an effect, either quantifiable or not, on the production of income for a particular year of assessment. It is however necessary that expenditure must have been laid out for the purpose of earning income for it to be deductible. Expenditure need not be causally related to the income (*CIR v Drakensberg Garden Hotel (Pty) Ltd*, 1960: 479H – 480A).

It has also been suggested that abortive expenditure, and which was incurred to produce income but which entirely failed to produce income, will be deductible (De Koker & Williams, 2018: §7.8).

In *CIR v Nemojim (Pty) Ltd*, Corbett JA, held that:

> *"It is correct, as argued by appellant's counsel, that in order to determine in a particular case whether moneys outlaid by the taxpayer constitute expenditure incurred in the production of the income, important, sometimes overriding, factors are the purpose of the expenditure and what the expenditure actually effects."* (*CIR v Nemojim (Pty) Ltd*, 1983: 947F).

In summary, there must be a sufficiently distinct and direct relationship or link between the expenditure incurred and the actual earning of the income (De Koker & Williams, 2018: §7.8).

(d) Trade requirement (sections 23(g) of the ITA)

Section 23(g) of the ITA is often referred to as the negative counterpart to the General Deduction Formula, and which prohibits the deduction of any moneys claimed as a deduction from income, to the extent to which such moneys were not laid out or expended for the purposes of trade.

Whether expenditure has been incurred for the purposes of trade will depend on the facts of each particular case. This was confirmed by Botha JA in *Solaglass Finance Co (Pty) Ltd v CIR*:

> *"The truth is, in my judgment, that there are no hard and fast rules for deciding whether a taxpayer's expenditure falls within or outside the ambit of the section; it is not possible to devise any precise universal test for determining whether expenditure comprises moneys 'exclusively laid out or expended for the purposes of trade'. In general, one can say no more than that the issue is to be resolved by examining the*

> *particular facts of each individual case."* (*Solaglass Finance Co (Pty) Ltd v CIR*, 1991: 281C – 281E).

"Trade" is defined in section 1(1) of the ITA:

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

The courts favour a wide interpretation of the abovementioned "trade" definition. The Appellate Division, per Grosskopf JA in *Burgess v CIR*, held that:

> *"It is well-established that the definition of trade, which I have quoted above, should be given a wide interpretation. In ITC 770(1953) 19 SATC 216 at p 217 Dowling J said, dealing with the similar definition of 'trade' in Act 31 of 1941, that it was 'obviously intended to embrace every profitable activity and . . . I think should be given the widest possible interpretation.'"* (*Burgess v CIR*, 1993: 181I).

The purpose for which expenditure was incurred is the decisive consideration in the application of section 23(g) of the ITA (*SIR v Ineson*, 1980: 858E), and the purpose and the intention for which expenditure is incurred is a question of fact (*SIR v John Cullum Construction Co (Pty) Ltd*, 1965: 706A).

(e) Not of a capital nature (section 11(a) of the ITA)

There is no all-encompassing and universal test for the determination of whether an amount of expenditure is of a capital or a revenue nature. The following judgments do however provide guidance:

Innes CJ, in *CIR v George Forest Timber Company Limited*, held that:

> "*Money spent in creating or acquiring an income-producing concern must be capital expenditure. It was invested to yield future profit and while the outlay did not recur, the income did. There was a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one was capital expenditure, the other was not.*" (*CIR v George Forest Timber Company Limited*, 1924: 25).
>
> and
>
> "*The reason was plain; in the one case it was spent to enable the concern to yield profits in the future; in the other it was spent in working the concern for the present production of profit.*" (*CIR v George Forest Timber Company Limited*, 1924: 26).

Watermeyer CJ, in *New State Areas Ltd v CIR*, held that:

> "*… the true nature of each transaction must be enquired into in order to determine whether the expenditure attached to it is capital or revenue expenditure. Its true nature is a matter of fact and the purpose of the expenditure is an important factor; if it is incurred for the purpose of acquiring a capital asset for the business, it is capital expenditure, even if it is paid in annual instalments; if, [on] the other hand, it is in truth no more than part of the cost incidental to the performance of the income-producing operations, as distinguished from the equipment of the income-producing machine, then it is revenue expenditure, even if it is paid in a lump sum.*" (*New State Areas Ltd v CIR*, 1946: 627).

In addition to the above, the courts have furthermore, and on numerous occasions applied various tests in order to determine whether an amount of expenditure is more closely connected to the income-producing operations of a taxpayer or the income-producing structure of a taxpayer.

2.2 Distinction between contingent liabilities for the purposes of financial accounting and income tax:

Before the research question is addressed, the nature of contingent liabilities for the purposes of income tax and financial accounting must be investigated.

In colloquial terms contingent liabilities refer to obligations whose existence will only be confirmed by the occurrence or no-occurrence of one or more uncertain future events (SARS, 2016a: 3).

From an accounting respective there are also nuanced technical differences between provisions and contingent liabilities.

For the purposes of this subsection all *italicised* terms shall be references to the terms as contemplated in relevant financial accounting standards as the context indicates.

(a) Financial accounting and reporting

As a point of departure, companies are generally[2] required to use the South African Statements of Generally Accepted Accounting Practice (SA GAAP) as a reporting framework (Koppeschaar et al., 2016: 2) for the compilation of general purpose financial statements (General Purpose Financial Statements).

The purpose of General Purpose Financial Statements are to provide useful information about the financial position, financial performance and cash flows of an entity to a wide range of users for making economic decisions (IAS 1, 2010: para 9).

SA GAAP is harmonised with IFRS (Koppeschaar et al., 2016: 2) and as such comprise the Conceptual Framework for Financial Reporting (Conceptual Framework) and formal accounting standards, i.e. the International Accounting Standards (IAS) and the International Financial Reporting Standards (IFRS) (the IASs and IFRSs are collectively referred to as the Accounting Standards).

[2] Exceptions apply to certain profit companies and other companies for which no financial reporting standards are prescribed by the Companies Act and the regulations thereto.

The Accounting Standards set out the recognition, measurement, presentation and disclosure requirements for General Purpose Financial Statements (Koppeschaar et al., 2016: 3). The IFRSs are based on the Conceptual Framework which sets out the concepts that underlie the preparation and presentation of financial statements for external users (Koppeschaar et al., 2016: 3). The Conceptual Framework was preceded by the Framework for the Preparation and Presentation of Financial Statements (the Framework) and some of the Accounting Standards are still based on the Framework (Koppeschaar et al., 2016: 8).[3] It is envisaged that the Conceptual Framework should serve as the principle foundation on which IFRSs should be founded (Koppeschaar et al., 2016: 8).

The elements of financial statements comprise, *assets*, *liabilities*, *equity*, *income* and *expenses* (Conceptual Framework, 2010: para 4.2). Although a technical evaluation of the accounting concepts relating to *liabilities*, *provisions* and *contingent liabilities* are beyond the scope of this study, the mentioned concepts will be considered briefly to illustrate the distinction between the classification of accounting *provisions* and *contingent liabilities*, and contingent liabilities for income tax purposes.

The objective of *IAS 37 – Provisions, Contingent Liabilities and Contingent Assets* (IAS 37) is to ensure that suitable recognition criteria and measurement bases are applied to *provisions*, *contingent liabilities* and *contingent assets*. Furthermore, IAS 37 also serves to ensure that sufficient information is disclosed in financial statements to enable the users of financial statements to understand the nature, timing and amount of *provisions*, *contingent liabilities* and *contingent assets* (Deloitte Touche Tohmatsu Limited (Deloitte), 2019c).

In terms of IAS 37 a *liability* is defined as a *"present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits."* (IAS 37, 1998: para 10).[4]

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[3] These Accounting Standards have not been updated.

[4] An obligating event is an event that creates a legal or constructive obligation and, therefore, results in an entity having no realistic alternative but to settle the obligation (IAS 37, 1998: para 10).

A *liability* should be recognised when it is probable that economic benefits will flow from the entity when the obligation to settle and the amount of the benefits to be given can be measured reliably (Koppeschaar et al., 2016: 19).

A *provision* is defined as a *liability* of uncertain timing or amount (IAS 37, 1998: para 10).[5] In terms of the Conceptual Framework a *provision* will only be recognised where the abovementioned definition of *liability* is met, and it is probable that future benefits associated with the item will flow to or from the entity and the cost or value thereof can be measured reliably (Koppeschaar et al., 2016: 17).

In terms of IAS 37 the following two instances will give rise to a *contingent liability*. Firstly, a *possible obligation* where the outcome is uncertain and not wholly within the control of the entity; and secondly, a *present obligation* which does not meet the recognition criteria of *provisions* (IAS 37, 1998: para 10). In summary, *liabilities* and *provisions* are recognised and measured; *contingent liabilities* are not recognised in terms of IAS 37.

All *provisions* are contingent due to the fact that they are either uncertain in timing or amount (IAS 37, 1998: para 12). In support of the latter, Koppeschaar et al. states that the difference between *contingent liabilities* and *provisions* ultimately relates to the "degree of fulfilment" of the requirements of *liability* as per the Conceptual Framework (Koppeschaar et al., 2016: 509 – 510).

In the context of IAS 37 the term *contingent liability* is used for *liabilities* that are not recognised based on the fact that their existence will only be confirmed on the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity (IAS 37, 1998: para 12). The legal nature and distinction between contingent liabilities and liabilities will be addressed below, and it will become clear that the accounting and income tax concepts relating to contingent liabilities do not necessarily correspond.

It must also be noted that where another Accounting Standard deals with a specific type of *provision* or *contingent liability*, that Accounting Standard must be applied (IAS 37, 1998:

[5] Provisions for depreciation, impairment of assets and doubtful debts are adjustments to the carrying amounts of assets and not provisions as contemplated in IAS 37 (IAS 37, 1998: para 18).

para 5). Examples are *IAS 11 – Construction Contracts*, *IAS 19 – Employee Benefits* and *IFRS 4 – Insurance Contacts* (IAS 37, 1998: para 5).

IAS 37 also confirms that financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in future. Therefore, only *liabilities* that exist at the end of the reporting period are recognised. No *provisions* are recognised for costs that need to be incurred to operate in future (IAS 37, 1998: para 18).

The measurement of *provisions* are based on the best estimate of the expenditure required to settle the present obligation at the end of the reporting period (i.e. balance sheet date) or to transfer it to a third party at that time (IAS 37, 1998: para 36 – 37).

Common examples of *provisions* include *provisions* for:

(i) Restructuring by sale of an operation;

(ii) Restructuring by closure or reorganisation;

(iii) Warranties;

(iv) Land contamination;

(v) Customer refunds; and

(vi) Onerous (loss-making) contracts.

(Deloitte, 2019c)

IFRS 3 Business Combinations deals, *inter alia*, with the accounting of when a purchaser (referred to as an *acquirer* in IFRS 3) obtains control of a *business*.

For the purposes of IFRS 3 a *business* is defined to mean:

> *"An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs*

or other economic benefits directly to investors or other owners, members or participants" (IFRS 3, 2017: Appendix A).[6]

The *acquirer* is *inter alia* required to recognise identifiable *assets* acquired and *liabilities* assumed, and all *assets* acquired and *liabilities* assumed in business combinations must be measured at their acquisition-date *fair value* (IFRS 3, 2017: para 3.10 and para 3.18).[7] The seller will de-recognise all *assets* acquired and *liabilities* assumed by the acquirer.

It is however irrelevant that from an accounting perspective that these amounts may be deductible (Oliver, 2007: 601), and as previously stated it has been confirmed by Watermeyer CJ that:

> *"…the Court is not concerned with deductions which may be considered proper from an accountant's point of view or from the point of view of a prudent trader, but merely with the deductions which are permissible according to the language of the statute." (Joffe & Co Ltd v CIR*, 1946: 359).

This will be further explored below.

(b) Income tax

There are no definitions for the terms "contingent", "liability" and/or "contingent liability" in the section 1(1) definitions clause of the ITA.

It is therefore necessary that the ordinary dictionary meaning of the mentioned terms be considered.

> Contingent (adjective) – *"Subject to chance; (of losses, liabilities, etc.) that can be anticipated to arise if a particular event occurs; True by virtue of the way things in*

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6 Please note that this definition has been amended for business combinations for which the *acquisition date* is after the beginning of the first annual reporting period beginning on or after 1 January 2020.

7 Exceptions to the recognition and measurement principles apply in respect of *contingent liabilities* arising in a business combination, employee benefits, indemnification assets, reacquired rights, share-based payment transactions and assets held for sale.

fact are and not by logical necessity; Occurring or existing only if (certain circumstances) are the case; dependent on." (English Oxford Living Dictionaries, 2019: "Contingent").

Liability (noun) – "*The state of being legally responsible for something; A thing for which someone is responsible, especially an amount of money owed; A person or thing whose presence or behaviour is likely to put one at a disadvantage."* (English Oxford Living Dictionaries, 2019: "Liablity").

From a common law perspective there is no definitive definition for contingent liabilities. Common traits and principles can however be delineated from case law where the deductibility of liabilities have been considered. The three most authoritative cases in this regard are dealt with below.

Firstly, in *Nasionale Pers Bpk v KBI*, the court's majority finding by Hoexter JA was based on the principle that liabilities should be both absolute ("volstrekte" [Afrikaans]) and unconditional ("onvoorwaardelik" [Afrikaans]):

"Die vereiste dat die onkoste "werklik aangegaan" moet word, het egter tot gevolg dat moontlike toekomstige uitgawes wat bloot as waarskynlik geag word nie ingevolge art 11 (a) aftrekbaar is nie. Alleen onkoste ten opsigte waarvan die belastingbetaler 'n volstrekte en onvoorwaardelike aanspreeklikheid op die hals gehaal het, mag in die betrokke belastingjaar afgetrek word." (*Nasionale Pers Bpk v KBI*, 1986: 564B – D).

In *Nasionale Pers Bpk v KBI* the taxpayer's liability to pay bonuses to employees were contingent on the relevant employees remaining in the employ of the taxpayer until 31 October, and which date was after the last day of the taxpayer's year of assessment. On the last day of the taxpayer's year of assessment, the liability to pay the bonuses was still contingent on the happening of uncertain future events (i.e. the staff remaining in the employ of the taxpayer). The bonus provision was therefore held not to be expenditure that had been actually incurred by the taxpayer during the relevant year of assessment.

Secondly, in *Edgars Stores Ltd v CIR*, the dispute concerned the date of the incurral of an amount which was only determined after the end of the taxpayer's year of assessment. In

short, the final amount of a rental expense for which the taxpayer would be liable was dependant on the turnover of the taxpayer for that year of assessment. At year end the final turnover had not yet been determined, and was thus contingent on the happening of an uncertain outcome of a future event. The turnover rental liability was thus a contingent liability.

Corbett JA held that:

> *"Thus it is clear that only expenditure (otherwise qualifying for deduction) in respect of which the taxpayer has incurred an unconditional legal obligation during the year of assessment in question may be deducted in terms of s 11(a) from income returned for that year. The obligation may be unconditional ab initio or, though initially conditional, may become unconditional by fulfilment of the condition during the year of assessment; in either case the relative expenditure is deductible in that year. But if the obligation is initially incurred as a conditional one during a particular year of assessment and the condition is fulfilled only in the following year of assessment, it is deductible only in the latter year of assessment (the other requirements of deductibility being satisfied)."* (*Edgars Stores Ltd v CIR*, 1988: 889A – 889C).

Lastly, and in *CIR v Golden Dumps (Pty) Ltd*, which concerned a dispute between a taxpayer and its former employee and its obligation to dispose of shares to its former employee. The court found that only on the finalisation of the dispute and if the claim is upheld that the expenditure would be incurred during that year of assessment. The taxpayer's liability towards the employee was therefore contingent on the dispute being finally decided by the court (*CIR v Golden Dumps (Pty) Ltd*, 1993: 118F – 118H). Nicholas AJA confirmed that:

> *"In the case of a liability which is contingent in the legal sense, the expenditure is incurred during the year of assessment only if the condition on which it depends is fulfilled during that year."* (*CIR v Golden Dumps (Pty) Ltd*: 1993: 119A).

The golden thread running through the above three cases is that a liability will be conditional where the occurrence of a future uncertain event will dictate the coming into existence of the taxpayer's obligations. This is also the point where it could be said that the contingent liability becomes an actual or an absolute liability.

At this point it is worth noting that SARS, in IN94, makes a further distinction between contingent liabilities on the basis of same constituting either "embedded statutory obligations" or "free-standing contingent liabilities". This distinction is a new concept in South African income tax law, and has to date not been tested in our courts. This is unpacked in chapter 5.

(c) Comparison: Income tax and financial accounting

Contingent liabilities and *provisions* for the purposes of IAS 37 will constitute contingent liabilities for the purposes of income tax law.

IAS 37 *contingent liabilities* will constitute contingent liabilities for income tax purposes based on the fact that the liabilities will either:

(i) only be confirmed on the occurrence or non-occurrence of one or more uncertain future events, not wholly within the control of the entity (IAS 37, 1998: paragraph 12); or

(ii) the amount of the obligation cannot be measured with sufficient reliability.

IAS 37 *provisions* are contingent liabilities for income tax purposes based on that fact that they are either uncertain in timing or amount (IAS 37, 1998: para 12), which is similar to the contingent liabilities referred to in the *Nasionale Pers Bpk v KBI*, *Edgars Stores Ltd v CIR* and *CIR v Golden Dumps (Pty) Ltd* cases.

Nicholas AJA held that:

> *"A prudent accountant would no doubt require that provision be made in the taxpayer's financial statements for the expenditure that might be incurred (see Financial Accounting (ubi cit)) but any reserve thereby created would not be a permissible deduction. Section 23(e) of the Act provides that no deduction shall in any case be made in respect inter alia of income carried to any reserve fund."* (*CIR v Golden Dumps (Pty) Ltd*, 1993: 118H – 118I).

Another important distinction to make is between IAS 37 *provisions* and *valuation provisions* such as *provisions for impairment* and *provisions for doubtful debt*. Although a decline in the value of the relevant *assets* is recognised in the financial statements, this will not lead to the incurral of expenditure on the part of the taxpayer (SARS, 2016a: 3).

2.3 Conclusion

What is clear from the above is that the accounting treatment and income tax treatment of contingent liabilities do not agree, and can generally be summarised by classification and effect as follows:

Table 1 – Accounting and Income Tax – Contingent Liabilities Comparison

	Characteristics according to IAS 37	**Classification and effect**	
		Financial Accounting and Reporting	***Income Tax***
1.	A present obligation arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.	*Liability* - Recognised - Measured - Disclosed Will have an effect on the financial position (Statement of Financial Position) and performance (Statement of Comprehensive Income) of the entity [company].	Liability - Deductible under section 11(a) of the ITA in the year of assessment in which it is incurred, provided that all requirements of the General Deduction Formula are met.
2.	A *liability* of uncertain timing or amount.	*Provision* - Recognised - Measured - Disclosed	Contingent liability - Not deductible under section 11(a) of the ITA.

	Characteristics according to IAS 37	Classification and effect	
		Financial Accounting and Reporting	***Income Tax***
		Will have an effect on the financial position (Statement of Financial Position) and performance (Statement of Comprehensive Income) of the entity [company].	
3.	A possible obligation where the outcome is uncertain and not wholly within the control of the entity or A present obligation which does not meet the recognition criteria of *provisions*.	*Contingent liability* - Disclosed in the notes to the General Purpose Financial Statements Will not have an effect on the financial position (Statement of Financial Position) and performance (Statement of Comprehensive Income) of the entity [company].	Contingent liability - Not deductible under section 11(a) of the ITA.

The recognition of *provisions* for the purpose of preparing General Purpose Financial Statements will therefore have an effect on the financial performance of a reporting entity through the Statement of Financial Position and the Statement of Profit and Loss and Other Comprehensive Income and thus the valuation of a business.[8]

[8] When a *provision* is recognised and measured for the first time it will have an effect on the financial performance of the entity by giving rise to an expense. The measurement of the *provision* in subsequent reporting periods (i.e. re-measurement) to the best estimate may give

Provisions will constitute contingent liabilities for income tax purposes; however notwithstanding the latter, *provisions* will not be deductible under section 11(a) of the ITA. Ordinarily the differences in respect of the treatment of *provisions* for the purposes of General Purpose Financial Statements and income tax will only give rise to temporary differences which will resolve over time when the relevant *provisions* (and *contingent liabilities*) become unconditional (i.e. when they are incurred).[9] However, in the case of the *provisions* that are assumed as part of the transfer of a going concern, and otherwise, there is a risk that permanent differences may arise.

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rise to income or expenses, depending on whether there is an increase or decrease in the valuation of the relevant *provision*.

9 This is based on the assumption that all other requirements of the General Deduction Formula are satisfied.

3. GENERAL INCOME TAX CONSIDERATIONS IN RESPECT OF THE SALE OF A GOING CONCERN

In this chapter, we will outline general considerations that are important in the structuring of the sale of a going concern from the perspective of sellers and purchasers, and in particular where the parties are required to decide how to deal with the seller's contingent liabilities.

3.1 Going concern

For the purpose of this chapter and the chapters that follow the term "going concern" shall be a reference to:

> "*all or a part of a business which is capable of separate operation and constitutes an income-earning activity in its own right at the date of sale"* (SARS, 2016a: 2).

3.2 Contingent liabilities – Structuring alternatives

Various structuring options may be employed by purchasers and sellers, and this includes *inter alia* the following:[10]

(a) Option one: The seller pays the purchaser to assume identified contingent liabilities

The seller may effect payment through a cash payment, the transfer of assets to the purchaser or a combination of the aforementioned.

In this arrangement the purchaser may be required to include the amount received from the seller in respect of the assumed contingent liabilities in its gross income for the purpose of determining its taxable income (SARS, 2016a: 6). The purchaser will in all likelihood argue for income tax deductions or allowances once the assumed contingent liabilities become unconditional (Jacobs, 2012: 47 – 48 and 50).

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[10] This is not intended to be an exhaustive list of all structuring alternatives or permutations and combinations thereof.

The purchaser may also wish to claim an allowance in respect of future expenditure on contracts in terms of section 24C of the ITA, should the requirements of same be satisfied. This is especially pertinent where the purchaser is required to include amounts received from the seller for assumption of contingent liabilities in its income gross income.

The seller may wish to deduct the amount paid to the purchaser from its income for the purposes of determining its taxable income in the year of assessment in which the amount is paid to the purchaser. Such amounts are arguably incurred or paid by the seller to rid itself of the contingent liabilities and not in settlement of the contingent liabilities.

(b) Option two: The purchase price is agreed to be the net asset value of the going concern

This arrangement involves determining the purchase price of the going concern by netting the liabilities (including the contingent liabilities) against the assets of the going concern. The purchaser is therefore only required to physically pay the net amount to the seller.

The purchaser may argue for a deduction of the amount incurred in respect of the contingent liabilities assumed when same become unconditional.

The seller may also wish to deduct the amount foregone in respect of the purchase price of the assets disposed from its income for the purposes of determining its taxable income. This arrangement was arguably employed by Ackermans Ltd and Pepkor (SA) Ltd in *Ackermans Ltd v CSARS* (Rossouw, 2010: 51), which is dealt with in more detail in chapter 4.

(c) Option three: The seller retains the contingent liabilities

Option three involves the seller retaining all (or certain) of the contingent liabilities relating to the going concern. The seller may then, in due course, become liable to settle any contingent liabilities so retained, and which become unconditional. The seller would then argue for a deduction. This option does not involve the assumption of contingent liabilities, and will not be considered in this study.

(d) Selection of structuring option

The election of the structuring option will ultimately depend on the particular factual circumstances governing the sale of the going concern, and the outcomes of the negotiations between the parties. Relevant considerations in this regard may include the following:

(i) whether the seller will dispose of the whole or a part of the going concern;

(ii) whether the seller will derive income following the disposal of the going concern;

(iii) whether an allowance in terms of section 24C of the ITA will be available to the purchaser; and

(iv) the purchase price allocation.

Each of the structuring alternatives will give rise to different income tax consequences for sellers and purchasers, and may include taxable benefits for the purchaser or the seller, and may require that certain amounts be included in the gross income of the relevant taxpayer depending on the circumstances.

What complicates the matter further is that there are compelling arguments for, and against, income tax deductions for sellers and purchasers in respect of options one and two (Jacobs, 2012: 51 – 62).

The income tax treatment of assumed contingent liabilities concern two discrete taxpayers and the income tax treatment and consequences for the seller do not impact on the tax treatment and consequences for the purchaser, and *vice versa*.

3.3 Purchase price allocation

A going concern does not constitute a single asset for the purposes of the ITA (*CIR v Niko*, 1940). It is thus in the interest of both sellers and the purchasers to agree to an allocation of the purchase price, especially in light of the fact that SARS will be entitled to make an allocation should the parties to the sale of business agreement fail to do so. In this regard it is

important that the facts and the intentions of the parties be clearly documented in the sale of business agreement (*Eveready (Pty) Ltd v CSARS*, 2012: para [11]). This will be determinative in establishing what amount(s), if any, accrue to the seller and the cost price of trading stock and the base cost of assets for the purposes of paragraph 20 of the Eighth Schedule of the assets acquired by the purchaser.

When the purchase price is allocated to individual items of a going concern (e.g. trading stock, capital assets, goodwill, etc.), the amounts allocated to items of a revenue nature (e.g. trading stock, etc.) will constitute gross income, and the balance will be receipts of a capital nature (Kruger et al., 2012: 48).

In light of the above, it has become convention to express purchase price allocation in respect of the following broad categories:

(i) assets, at the accounting book value;

(ii) trading stock, at cost;

(iii) book debts, at the accounting book value (less provisions for doubtful); and

(iv) goodwill, as the balance,

(Kruger et al., 2012: 48 – 49).

It is worth noting that contingent liabilities may be relevant in the determination of the value of a going concern for the purpose of a sale agreement, but will not necessarily be relevant to the determination of the value of the discrete assets comprising the going concern for accounting and income tax purposes. A suitable purchase price allocation is therefore required.

SARS, in IN94, states that it will generally apply the purchase price allocation as set out in the sale of business agreement to both the seller and the purchaser (SARS, 2016a: 5).

3.4 Allowance in respect of future expenditure on contracts (section 24C of the ITA)

In most cases where a business is sold as a going concern, contracts will be transferred from the seller to the purchaser. The purchaser will "step into the shoes" of the seller in respect of the seller's obligations under the transferred contracts, and this may include the assumption of contingent liabilities.

Section 24C of the ITA was introduced to address the anomaly that arises when income is received during a year of assessment and the related deductible expenditure is only incurred in subsequent years of assessment (SARS, 2014b: 2).

Section 24C of the ITA provides as follows:

"24C. Allowance in respect of future expenditure on contracts

*(1) For the purposes of this section, "**future expenditure**" in relation to any year of assessment means an amount of expenditure which will be incurred after the end of such year-*

(a) in such manner that such amount will be allowed as a deduction from income in a subsequent year of assessment; or

(b) in respect of the acquisition of any asset in respect of which any deduction will be admissible under the provisions of this Act.

(2) If the income of any taxpayer in any year of assessment includes or consists of an amount received by or accrued to him in terms of any contract and such amount will be utilised in whole or in part to finance future expenditure which will be incurred by the taxpayer in the performance of the taxpayer's obligations under such contract, there shall be deducted in the determination of the taxpayer's taxable income for such year such allowance (not exceeding the said amount) in

respect of so much of such future expenditure as relates to the said amount.

... " [underlined own emphasis].

The requirements for "future expenditure" to be deductible are the following:

(i) A taxpayer's income for a particular year of assessment must include or consists of an amount received by or accrued in terms of a contract; and

(ii) such amount will be utilised in whole or in part to finance future expenditure, as defined in section 24C(1) of the ITA, which will be incurred by the taxpayer in the performance of the taxpayer's obligations under such contract.

Should the above requirements be satisfied, the taxpayer will be allowed to deduct in the determination of its taxable income for such year such allowance (not exceeding the said amount) in respect of so much of such future expenditure as relates to the said amount.

In terms of section 24C(3) of the ITA, any allowance deducted under section 24C(2) in any year of assessment shall be deemed to be income received by or accrued to the taxpayer in the following year of assessment (i.e. the reversal step).

SARS is of the view that the taxpayer claiming the section 24C allowance must be able to show that there is *"a high degree of probability and inevitability that expenditure will be incurred by the taxpayer"* in a subsequent year of assessment (SARS: 2014b: 8 – 9).

It was held in *ITC 1601* that:

> *"Counsel for the Commissioner, in my view, correctly contended that the Commissioner will not be satisfied that future expenditure will be incurred where there is only a contingent liability. There must be a clear measure of certainty as to whether the expenditure in contention is quantified or quantifiable. The onus that the appellant bears here is to satisfy the Commissioner that the agreements relied upon will lead to deductible expenditure, in the following year."* (ITC 1601, 1995: 179).

It is clear that this is a fact specific inquiry and that each case must be determined on its own merits. Special cases include warranties claims and maintenance contracts (SARS: 2014b: 14 – 15). ITC 1601, however, casts doubt in respect of whether "future expenditure" in respect of contingent liabilities will be allowed under section 24C of the ITA, and if allowed, how the amount of the allowance should be calculated.

Possible anomalous results in the year that the contracts are transferred from a seller to a purchaser include the following:

(i) *Seller*

- To the extent that the seller deducted section 24C allowances in respect of a transferred contract, it will be required, in terms of section 24C(3) of the ITA, to include the amount of the prior year deduction in its income.

- It is unclear if the seller will be entitled to a deduction of the amounts paid to purchaser or forgone (i.e. the "advance income") to assume its contingent obligations under the transferred contracts.

- The seller may thus be in a position where it is taxed on "advance income" without being able to claim the attendant income tax deduction.

(ii) *Purchaser*

- The purchaser will be required to include the "advance income" in its income for the purposes of determining its taxable income.

- Provided that the requirements of section 24C of the ITA are met, the purchaser will be entitled to deduct an allowance in respect of "future expenditure" (limited to the amount of the "advance income" received by or accrued to it).

Sellers and purchasers should therefore carefully consider the requirements of section 24C of the ITA prior to agreeing to advance payments for the assumption of contingent liabilities.

SARS is also of the view that this analysis should be done on a contract-by-contract basis (SARS, 2014b: 24).

4. REVIEW OF RELEVANT CASE LAW AND ADVANCE RULINGS PUBLISHED BY SARS

In this chapter a review of relevant case law and advance rulings published by SARS will be conducted to highlight uncertainties regarding the taxation of contingent liabilities assumed as part of a sale of a going concern.

4.1 *Ackermans Ltd v CSARS*

(a) Facts of the matter

In the Ackermans case, the Tax Court and the Supreme Court of Appeal were confronted with a sale of business transaction whereby Ackermans Limited (Ackermans), being the seller, disposed of its retail clothing business (retail business) as a going concern to Pep Stores (SA) Limited (Pepkor), the purchaser.

The purchase price, payable by Pepkor, was defined in the sale of business agreement as "*the amount equal to the sum of R800m and the rand amount of the liabilities*", i.e. R1 129 440 402, which was made up as follows, R800 000 000 plus R329 440 402 (*Ackermans Ltd v CSARS*, 2011: para [4]).

Included in the liabilities assumed by Pepkor were three contingent liabilities totalling R17 174 777, in respect of Ackermans's obligations:

(i) to fund post-retirement medical aid benefits for its employees (R9 880 666);

(ii) to employees in terms of Ackermans's long-term bonus scheme (R6 394 111); and

(iii)for repairs to be undertaken under the Ackermans's property leases (R900 000),

(collectively the Contingent Liabilities)

The crisp legal question before the Tax Court and the Supreme Court of Appeal was whether Ackermans was entitled to claim the R17 174 777 as a deduction in terms of section 11(a) of

the ITA, which amount, according to Cloete JA, was essentially forgone by Ackermans in terms of the sale of business agreement between Ackermans and Pepkor.

The court accepted that had Ackermans retained the retail business and continued its trade, the three Contingent Liabilities would have been deductible in its hands, as and when they became unconditional (*Ackermans Ltd v CSARS*, 2011: para [3]).

(b) ITC 1839 (*court a quo*) – Judgment

At this point it is worth noting that the court *a quo*, considered and made findings in respect all of the elements of the General Deduction Formula, and per Wallis J found that:

(i) Expenditure and losses

The seller suffered no diminution of patrimony or loss; on the contrary the seller was relieved of the risk that the Contingent Liabilities would materialise (ITC 1839, 2009: para [26]);

(ii) Actually incurred

Until such time that the Contingent Liabilities become unconditional, it does not constitute expenditure "incurred", as there is no obligation on the seller to make payment (ITC 1839, 2009: para [30]);

(iii) In the production of income

The "notional agreement expenditure" had not been incurred in the production of income prior to the sale of the retail business, but was instead incurred to induce the purchaser to assume the Contingent Liabilities (ITC 1839, 2009: para [31]);

(iv) Revenue or capital

The sale of the retail business by its nature resulted in the cessation of the seller's trade, and the seller failed to successfully argue that the expenditure incurred would

have been more closely connected to its income earning operations, and thus of a revenue nature (ITC 1839, 2009: para [32]);

(v) Trade

Expenditure was not laid out, or expended, for the purposes of the seller's trade. The transaction(s) were undertaken to enable the seller to sell the retail business to the purchaser as a going concern and to bring to an end the seller's trading activities (ITC 1839, 2009: para [33]); and

(vi) Purpose of the "notational agreement expenditure"

The "notional agreement expenditure" was incurred in order to induce the purchaser to assume the Contingent Liabilities and was not incurred in the production of income prior to the sale of the retail business, and a deduction would have been disallowed in terms of section 23(f) of the ITA (ITC 1839, 2009: para [35]).

The seller contended that expenditure incurred to rid itself of anticipated or contingent revenue expenses is generally itself of a revenue nature (ITC 1839, 2009: para [21]). Interestingly, Wallis J suggested that if on the construction of the seller an amount had been "paid" to relieve itself of the Contingent Liabilities that it would arguably have been "expenditure" and it would have been "actually incurred" (ITC 1839, 2019: para [31]).

However, as set out above, the Tax Court was of the view that the seller failed to satisfy all of the requirements of the General Deduction Formula, and the section 11(a) deduction was therefore correctly disallowed by SARS.

(c) Supreme Court of Appeal – Judgment

The Supreme Court of Appeal, per Cloete JA, held the following:

(i) *"'Expenditure incurred' meant the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability."* (*Ackermans Ltd v CSARS*, 2011: para [8]);

(ii) *"No liability was incurred by Ackermans to Pepkor in terms of the sale agreement."* (*Ackermans Ltd v CSARS*, 2011: para [8]);

(iii) *"The fact that Ackermans rid itself of liabilities by accepting a lesser purchase price than it would have received had it retained the liabilities, does not mean in fact or in law that it incurred expenditure to the extent that the purchase price was reduced by the liabilities."* (*Ackermans Ltd v CSARS*, 2011: para [11]); and

(iv) *"At the effective date no expenditure was actually incurred by Ackermans."* (*Ackermans Ltd v CSARS*, 2011: para [11]).

Cloete JA further stated that:

> *"It is clear that what occurred, as is usually the case in transactions of this nature, is that the net asset value of the business ─ the assets less the liabilities ─ was calculated and that this valuation dictated the purchase price."* (*Ackermans v CSARS*, 2011: para [10]).

Accordingly the Supreme Court of Appeal was of the view that the manner in which the purchase price was discharged did not result in the discharge of any obligation owed by the seller to the purchaser; and the seller owed the purchaser nothing in terms of the sale of business agreement (*Ackermans Ltd v CSARS*, 2011: para [7]).

(d) Critique of the judgments

The Supreme Court of Appeal has been criticised for taking an overly formalistic approach to this matter. It was questioned in an editorial note to *The Taxpayer*; why would the law recognise expenditure of R329 440 402 if the sale of business agreement had been structured so that seller received R1 129 440 402 and at the same time incurred an obligation to pay purchaser an amount of R329 440 402 to assume its liabilities (i.e. including the Contingent Liabilities), but denies that expenditure was incurred where the same commercial result is achieved by netting the amounts off (i.e. R1 129 440 402 *less* R329 440 402) (The Taxpayer, 2010: 237).

Apart from the finding in the Supreme Court of Appeal regarding whether expenditure was incurred, the court's judgment does not provide guidance regarding how courts should approach the remaining requirements of the General Deduction Formula, i.e.

(i) in terms of sections 11(a) and 23(f) of the ITA – whether expenditure was incurred "in the production of income"; and

(ii) in terms of sections 11(a) and 23(g) of the ITA – whether monies were laid out or expended for the purposes of the seller's trade.

It has been argued that the Ackermans case might have been better determined on the aforementioned grounds (The Taxpayer, 2010: 237).

A further criticism is that the Supreme Court of Appeal dismissed many of the arguments put forth on behalf of the seller, and without sufficient substantiation. These arguments included whether, as envisaged in section 11(a) of the ITA, Ackermans suffered a loss, and which Cloete JA dismissed without any substantiation (Ger & Chong, 2011); and whether Ackermans incurred expenditure to rid itself of anticipated or contingent revenue expenses (Germishuys & McGregor, 2014: 445).

(e) Deductions by the purchaser

In an *obiter* statement, Cloete JA held that there would be no bar to the purchaser (i.e. Pepkor) deducting the Contingent Liabilities as and when they become unconditional. Although SARS was in agreement with this view (*Ackermans Ltd v CSARS*, 2011: para [9]), the court did not substantiate this statement.

SARS, in certain of its advance rulings (see below), have ruled that purchasers can claim section 11(a) deductions in respect expenditure incurred in respect of assumed contingent liabilities. Notwithstanding the above, there is a risk that a court may deny a taxpayer a deduction, and for example, take the view that expenditure incurred by a purchaser in respect of assumed contingent liabilities is of a capital nature (Ger & Chong, 2011).

(f) Employment-related contingent liabilities

From an employment perspective it could also be argued that in terms of the section 197 of the LRA employment relationships are transferred from the seller to the purchaser. In terms of sections 197(7) and 197(8) of the LRA, the seller, being the *old employer*, and the purchaser, being the *new employer*, are jointly and severally liable for a period of 12 months after the transfer of the business to any employee who becomes entitled to receive a payment of:[11]

(i) leave pay accrued to the transferred employees;

(ii) the severance pay that would have been payable to the transferred employees of the older employer in the event of a dismissal by reason of the employer's operational requirements; and

(iii) any other payments that have accrued to the transferred employees, but have not been paid to the employees of the *old employer*. This would include for example an employee's entitlement to post-retirement medical aid benefits, entitlements under long-term bonus schemes, etc.

In terms of the section 197(2) of the LRA, and unless otherwise agreed, the *new employer* is automatically substituted in the place of the *old employer* in respect of all contracts of employment in existence immediately before the date of the transfer, and all rights and obligations between the *old employer* and an employee at the time of the transfer continue in force as if they had been rights and obligation between the *new employer* and the employee.

It has been argued that the Ackermans judgment creates a problem in that section 197 of the LRA obliges the seller and the purchaser to provide for the aforementioned employment-related expenses, however the ITA denies the seller and the purchaser a deduction in respect of same (Germishuys & McGregor, 2014: 439).

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[11] In the context of section 197 of the LRA the "transfer" of a "business" entails the transfer of a "business" which "includes the whole or a part of any business, trade, undertaking or service" from one employer (the *old employer*) to another employer (the *new employer*) as a going concern.

Germishuys & McGregor is further of the view that the purchaser would seek a deduction in respect of these employment-related contingent liabilities once they become enforceable, and the seller would similarly seek to deduct any amount paid in respect of the aforementioned contingent liabilities, should the seller become liable for same (Germishuys & McGregor, 2014: 440).

Germishuys & McGregor are of the view that in the Ackermans case, the seller created an unconditional legal obligation by the agreement reached between the seller and the purchaser, as required in terms of section 197 of the LRA, and which is reflected in the sale of business agreement. Consequently, and as set out in the *Edgars Stores Ltd v CIR*, "expenditure" was "actually incurred" as an unconditional legal obligation existed (Germishuys & McGregor, 2014: 441).

Germishuys & McGregor argue that the seller and the purchaser agreed that the seller would be liable to discharge employment-related obligations in respect of the transferred employees which had accrued up to and including the effective date of the sale of the business (Germishuys & McGregor, 2014: 444).

Germishuys & McGregor are of the view that Ackermans made an argument for a deduction on the following grounds:

(i) Had the seller retained the business and continued to trade, the employment-related contingent liabilities would have been deductible in its hands, had same become unconditional; and

(ii) The seller did not argue for a deduction of the contingent liabilities, and which Cloete JA accepted (*Ackermans Ltd v CSARS*, 2011: para [5]), but argued for a deduction in respect of the expenditure it incurred in terms of the sale of business agreement and which was equal to the sum of the contingent liabilities, i.e. expenditure was incurred to free itself of the anticipated or contingent revenue expenses (Germishuys & McGregor, 2014: 445).[12]

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12 Cloete JA, however, held that it was unnecessary to consider if this argument was correct (*Ackermans Ltd v CSARS*, 2011: para [5]).

Germishuys & McGregor disagree with Cloete JA's view that the deduction claimed by the seller was not "expenditure" and not "actually incurred", and they argue that in terms of the sale of business agreement, read with section 197 of the LRA, the seller had a definite and an unconditional obligation, and "expenditure" was "incurred" (Germishuys & McGregor, 2014: 445). They are thus critical of Cloete JA's view that:

> *"I cannot accept this argument. To my mind, 'expenditure incurred' means the undertaking of an obligation to pay or (which amounts to the same thing) the actual incurring of a liability. No liability was incurred by Ackermans to Pepkor in terms of the sale agreement. The manner in which the purchase price was discharged by Pepkor did not result in the discharge of any obligation owed by Ackermans to Pepkor. Ackermans owed Pepkor nothing in terms of the sale agreement and one looks in vain for a clause in that agreement that has this effect."* [underlined own emphasis] (*Ackermans Ltd v CSARS*, 2011: para [8]).

The seller had incurred a liability to the purchaser in terms of the sale of business agreement and the apportionment of liabilities, as required under section 197 of the LRA (Germishuys & McGregor, 2014: 446).

Regarding concerns of "double deductions", Germishuys & McGregor argue that as the seller paid his pro-rate part of the employment-related contingent liabilities, the purchaser will only be out of pocket and pay employment-related contingent liabilities accumulated while the transferred employees are in its employ (Germishuys & McGregor, 2014: 447).

The above analysis by Germishuys & McGregor makes a strong argument that the assumption of contingent liabilities relating to employment relationships between employees and the *old employer*, on the one hand, and the employees and the *new employer* requires special consideration by Treasury and Parliament.

(g) Alternative interpretations of sale of business agreements

The Supreme Court of Appeal judgment suggests that had the sale of the business agreement been worded differently, the assumption of the Contingent Liabilities could have been seen to give rise to expenditure that is incurred in the production of income; and it has been argued

that the focal point of the Tax Court and the Supreme Court of Appeal's judgments were a reliance on the construction of the sale of business agreement (Jacobs, 2012: 3).

The Ackermans case serves as a cautionary tale, alerting prospective sellers and purchasers of a going concern to the pitfalls of unclear contractual drafting.

(h) Conclusion

It is clear that various writers do not agree with the position adopted by the Tax Court and the Supreme Court of Appeal in the Ackermans case. The differing views stem from a disagreement of the interpretation of the sale of business agreement and the application of the ITA to same.

For the reasons set out above, there are still many unresolved questions, which makes the drafting of sale of business agreements all that more complicated.

4.2 Binding private rulings (BPRs)

In addition to the case law discussed above, SARS has to date published seven BPRs in which the taxation of contingent liabilities have been considered, and which BPRs are discussed below.

In terms of section 76 of the TAA, the purpose of the "advance ruling" system is to promote clarity, consistency and certainty regarding the interpretation and application of a tax act.

While the BPRs do not constitute a "practice generally prevailing", as contemplated in section 5(1) of the TAA, and only applies to the persons identified as the applicants in the BPRs (see sections 82 and 83 of the TAA), the BPRs provide insight into SARS's reasoning and policy.
Terms defined under this subheading and further subheadings hereunder, will only apply in respect of this subheading and such further subheadings.

(a) One: BPR 122 – Transfer of a business of a company as a going concern to its holding company as a result of an amalgamation or merger transaction

Applicant was a company resident in South Africa and held 100% of the shares in Co-Applicant, a South African resident company. Together Applicant and Co-Applicant constituted a group of companies as defined in section 41(1) of the ITA.

The proposed transaction would see the transfer of Co-Applicant's business, as a going concern, to Applicant in terms of either an amalgamation or a merger transaction.

The contingent liabilities that would be assumed by Applicant included:

(i) Provision for leave pay;

(ii) Bonus provision;

(iii) Long-term incentive for executives;

(iv) Deferred bonus incentive provision; and

(v) Incentive provision where conditions for paying the incentive have not been satisfied,

(collectively the Contingent Liabilities).

The ruling was made subject to the following conditions:

(i) That the Contingent Liabilities to be assumed by Applicant would not be claimed and/or allowed as a section 11(a) deduction by Co-Applicant.

(ii) Section 23E of the ITA applies in respect of any leave provision.[13]

[13] Section 23E of the ITA has been repealed and replaced by section 7B of the ITA with effect from 1 March 2013.

Applicant would be entitled to deduct "expenditure actually incurred", which relates to the Contingent Liabilities under section 11(a) read with section 23(g).

(b) Two: BPR 185 – Corporate rules: disposal of assets and liabilities as part of a group restructure

The proposed transactions involved the disposal of assets and the transfer of liabilities and contingent liabilities in terms of section 42 of the ITA.

Applicant was a listed company resident in South Africa. NewCo was a newly incorporated company resident in South Africa, and was wholly-owned by Applicant. The SubCos were companies resident in South Africa and wholly-owned by Applicant.

The proposed transaction steps were as follows. Applicant would transfer certain assets to NewCo in terms of sections 42 and 40CA of the ITA. As consideration for the latter NewCo would assume the liabilities and contingent liabilities of Applicant and thereafter issue equity shares to Applicant based on the net asset value of the assets, liabilities and contingent liabilities transferred.

The contingent liabilities that would be assumed by NewCo included provisions in respect of:

(i) Leave pay;

(ii) Incentives/bonuses;

(iii) Environmental rehabilitation;

(iv) Share incentive scheme; and

(v) Post-retirement medical aid benefits,

(collectively the Contingent Liabilities).

The ruling was made subject to the following conditions and assumptions:

(i) That Applicant would transfer to NewCo all assets, liabilities and contingent liabilities attributable to and which arose in the normal course of the business undertaking that will be disposed of as a going concern; and

(ii) That section 197(2)(a) to (d) of the LRA would apply and that NewCo would not have recourse to Applicant for the Contingent Liabilities assumed.

In respect of the Contingent Liabilities assumed, excluding the environmental rehabilitation Contingent Liabilities, SARS ruled that expenditure incurred in relation to the Contingent Liabilities would be deductible by NewCo provided that the requirements of section 11(a) read with sections 7B and 23(g) of the ITA are met when they materialise.

A further requirement in this ruling was that:

> *"In assessing whether or not the requirements of the above-mentioned mentioned sections are met, expenditure must be evaluated within the context of the nature of the going concern business as carried on by the Applicant prior to the transfer and by NewCo subsequent to the transfer, without regard to the fact that the assumption of that obligation by NewCo was part of the consideration for the acquisition of the assets. The circumstances under which the contingent liability arose in the hands of the Applicant are therefore relevant."* (SARS, 2014a: 3).

Similarly, and with regard to the environmental rehabilitation provision assumed, expenditure incurred by NewCo in making future payments would be deductible under section 37A of the ITA provided the requirements under that section are met. Again, SARS stated that no regard must be had to the fact that assumption of the obligation by NewCo was part of the consideration for the acquisition of the assets.

(c) Three: BPR 204 – Definition of "Disposal" for purposes of asset-for-share and amalgamation transactions; "Qualifying Distribution" upon conversion to a corporate real estate investment trust

The proposed transaction involved the conversion of a portfolio of a collective investment scheme in properties (CISP), which was listed as a Real Estate Investment Trust (REIT), to a corporate REIT. Prior to the conversion it was envisaged that the immovable property will be transferred to a property holding company.

Although it is mentioned that the letting enterprises of the CISP includes contingent liabilities, no mention was made of the income tax consequences for the seller and purchaser in respect of the contingent liabilities that were to be transferred.

(d) Four: BPR 210 – Liquidation distribution followed by an amalgamation transaction

The parties were Applicant, Co-Applicant and SubCo; who were all incorporated and resident in South Africa. Applicant and Co-Applicant were subsidiaries of common shareholders. SubCo was a wholly-owned subsidiary of Applicant.

The proposed transaction steps comprised, firstly a liquidation distribution in terms of section 47(1) of the ITA and secondly an amalgamation transaction in terms of section 44(1) of the ITA. The rational for the proposed transactions were to consolidate the operations of the parties.

(i) The liquidation distribution would see the distribution of all of SubCo's assets (SubCo did not have any liabilities) to Applicant.[14]

(ii) The amalgamation transaction would see the transfer by Applicant of all of its assets to Co-Applicant as a going concern. The purchase consideration would be discharged by the assumption by Co-Applicant of Applicant's debts and contingent liabilities and the issue of shares by Co-Applicant to Applicant.

[14] This BPR does not state whether the assets were transferred to Applicant as a going concern.

The ruling is silent on the income tax consequences for the seller and purchaser relating to the assumed contingent liabilities.

(e) Five: BPR 233 – Transfer of a part of a business to a fellow subsidiary

In this ruling the parties were Applicant, Co-Applicant and NewCo; and who were all companies incorporated and resident in South Africa. Co-Applicant and NewCo were newly incorporated companies.

The proposed transaction would see the holding company of Applicant transfer its shares in Applicant to NewCo in exchange for shares in NewCo. Applicant would thereafter sell its shares in its operating subsidiaries to NewCo who would act as the holding company of the South African operating subsidiaries. Co-Applicant would be a wholly-owned subsidiary of NewCo.

Applicant would then sell its non-financial services business and the group's common infrastructure to Co-Applicant in terms of a section 45 of the ITA.

Co-Applicant would assume the contingent liabilities of Applicant relating to:

(i) Performance of administrative services, and paying the cost of motor vehicle services in terms of customer contracts and prepaid corporate client contracts (collectively the Contracts); and

(ii) Leave pay obligations existing at effective date in respect of employees transferred to Co-Applicant,

(collectively the Contingent Liabilities).

It is important to note that the Contingent Liabilities relating to the Contracts were not assumed by Co-Applicant in part settlement of the purchase price of the business.

In the ruling SARS held that the receipt by or accrual of any amount by Co-Applicant as consideration for the assumption of the contingent liabilities under the Contracts would be

included in Co-Applicant's gross income. Co-Applicant would be entitled to an allowance in respect of future expenditure on contracts under section 24C of the ITA based on the amounts included in its income and would also be entitled to deductions when expenditure under the Contract were incurred.

Co-Applicant would not be entitled to a deduction in respect of the incurral or the payment of leave pay obligations existing at the effective date and as taken over in terms of a sale of business agreement. It was stated in the ruling that Co-Applicant would receive cash payments from Applicant in respect of the assumed leave pay obligations in respect of the employees transferred to Co-Applicant. The ruling states that Co-Applicant would not realise a capital gain or loss in respect of the payments received.

The ruling is silent regarding the income tax consequences for Applicant in respect of the payments made to Co-Applicant by Applicant.

(f) Six: BPR 266 – Acquisition of a business in exchange for the assumption of liabilities and the issuing of a loan note

The parties to the proposed transaction were Applicant, Company A and HoldCo. Applicant and HoldCo were companies incorporated and resident in South Africa. Company A was established in a foreign country and was resident in South Africa. HoldCo held 100% of the shares in Applicant and Company A.

As part of the rationalisation of the group, it was envisaged that Applicant would acquire the business of Company A. The purchase price would be discharged through the assumption by Applicant of Company A's liabilities and contingent liabilities and the issuing of a loan note in favour of Company A.
The contingent liabilities that would be assumed by Applicant included provisions in respect of:

(i) Leave pay;

(ii) Bonuses; and

(iii)Post-retirement medical aid,

(collectively the Contingent Liabilities).

SARS held that the expenditure incurred by Applicant in respect of the Contingent Liabilities would be deductible subject to the following conditions. In respect of the leave pay and bonus provisions that the requirements of section 11(a) read with sections 7B and 23(g) of the ITA must be met when these Contingent Liabilities materialise. In respect of the post-retirement medical aid provision that the requirements of section 11(a) read with section 23(g) of the ITA must be met.

This ruling, as in BPR 185, states that in assessing whether the requirements of section 11(a) read with sections 7B and 23(g) of the ITA are met, expenditure must be:

> *"evaluated within the context of the nature of the going concern's business as was carried on by Company A prior to the proposed transaction and by the Applicant subsequent to the proposed transaction without considering the fact that the assumption of the contingent liabilities by the Applicant will be part of the consideration for the acquisition of Company A's business. The circumstances under which the contingent liabilities arose in Company A will therefore be relevant".*

(g) Seven: BPR 308 - Assumption of contingent liabilities and the cession of a right of recovery

In this ruling the parties were Applicant, Co-Applicant 1 and Co-Applicant 2; all of whom were companies resident in South Africa. Co-Applicant 2 is a wholly-owned subsidiary of Co-Applicant 1, a listed company.

Applicant, the owner and operator of various mines, and Co-Applicant 1 entered into a captive mine arrangement (the Supply Agreement), whereby Applicant sold the products of a mine exclusively to Co-Applicant 1. Co-Applicant 1, in terms of the Supply Agreement, undertook to refund the bulk of the expenditure that Applicant would be liable to incur in respect of the rehabilitation of the mine.

In terms of the proposed transaction Co-Applicant 2 was to acquire the mine from Applicant as follows:

(i) Co-Applicant 2 would purchase all of the assets pertaining to the mine at a nominal price of one Rand.

(ii) Co-Applicant 2 would assume all of the liabilities pertaining to the mine, including the environmental rehabilitation obligations, in one indivisible transaction.

(iii) Co-Applicant 2 would acquire by way of cession from Applicant, the right of recovery against Co-Applicant 1 that it had in terms of the Supply Agreement (i.e. Co-Applicant 2 would be entitled to claim payment from Co-Applicant 1 upon the requisite payment of the respective rehabilitation,

(the Purchase and Sale Agreement).

The contingent liabilities assumed by Co-Applicant 2 in terms of the Purchase and Sale Agreement were:

(i) the environmental liabilities;

(ii) the rehabilitation obligation;

(iii) all statutory liabilities (including any historic liability) for the rehabilitation and closure of the mine;

(iv) all of the other obligations in terms of the mining rights, whether by virtue of the terms and conditions attaching to the mining rights, the Mineral and Petroleum Resources Development Act 28 of 2002 or any other applicable law; and

(v) Applicant's liabilities to the employees which arose on or after 1 October 2015,

(collectively the Contingent Liabilities)

According to the ruling, all of the abovementioned Contingent Liabilities constituted Embedded Contingent Liabilities for the purpose of the BPR.[15] "Embedded Statutory Obligations" are addressed in chapter 5.

SARS held that the Contingent Liabilities to be assumed by Co-Applicant 2 in terms of the Purchase and Sale Agreement would not be required to be included in Applicant's consideration for the purpose of:

(i) Section 1(1) "gross income", including paragraph (j) thereunder which deals with amounts received or accrued in respect of disposals of assets, the cost of which has in whole or in part have been included in capital expenditure or taken into account for the purpose of any deduction in respect of any mine under section 15(1) of the ITA.

(ii) Section 37 of the ITA, which deals with the calculation of capital expenditure on the sale, transfer, lease or cession of mining property; and

(iii) Proceeds, under paragraph 35 of the Eighth Schedule.

Furthermore, SARS held that:

(i) No amount will be received by or accrue to Applicant upon the rehabilitation right of recovery becoming unenforceable.

(ii) No amount will be received by or accrue to Applicant as a result of Applicant ceding the right of recovery to Co-Applicant 2.

(iii) The cession of the right of recovery will not result in a capital gain or loss for Applicant, as no expenditure will be incurred in relation to the right of recovery and no consideration will be received in respect of the cession to Co-Applicant 2.

15 This appears to be a reference to "Embedded Statutory Obligations" as discussed in IN94.

(h) Conclusion

The BPRs considered addressed different transactions and it appears that the majority of transactions considered in the rulings are subject to group relief under the Corporate Rules of the ITA.

No clear principles are set out in the BPRs. This is not surprising, as SARS is required to make rulings based on the facts particular to each advance ruling application. All of the facts pertaining to rulings are not necessarily set out in the published version of the rulings, and there is thus a risk that certain facts that may have swayed SARS to a particular view or interpretation may not be included in a published ruling.

Sellers and purchasers should therefore be cautious when the BPRs are considered or used to inform their decisions regarding the structuring of the sale of a going concern and the assumption of contingent liabilities.

4.3 Final remarks regarding the Ackermans case and the BPRs in respect of purchasers

The Ackermans case is based on a narrow set of facts, which are not common across all cases where contingent liabilities are assumed as part of the sale of a going concern, and is therefore of limited assistance in respect of instances where the facts are not aligned to that of the Ackermans case.

The income tax consequences for the purchaser were not addressed at all in the Supreme Court of Appeal's judgment. The lack of authoritative judicial guidance is not ideal. Although, and as illustrated above, many of the BPRs address the income tax consequences for purchasers, they are scant on details and thus of little assistance.

5. A CRITICAL ANALYSIS OF IN94

In this chapter relevant aspects of IN94 are analysed in order to determine whether uncertainties regarding the taxation of assumed contingent liabilities from the seller and the purchaser's perspective have been addressed by SARS.

5.1 Purpose and scope of IN94

As a point of departure, the stated purpose of IN94 is the following:

> *"This Note sets out the income tax implications for the seller and purchaser when the purchase price of assets acquired as part of a going concern is settled or partly settled by the assumption of contingent liabilities."* (SARS, 2016a: 2).

From the above quoted text, it is clear that SARS recognises that in principle the assumption of contingent liabilities, i.e. the undertaking to settle a seller's contingent liabilities if and when the contingent liabilities materialise, can be employed to settle the purchase price of a going concern (SARS, 2016a: 2).

SARS accepts that there are alternative ways to structure the sale of a going concern, however IN94 does not deal with a situation in which the seller and the purchaser agree that the seller pays the purchaser to take over contingent liabilities and such contingent liabilities are set-off against the liability owed by the purchaser to the seller for the acquisition of the going concern (SARS: 2016a:12).

> *"Different courses of action and different facts may have different tax consequences even when the economic effect is the same. Taxpayers are free to choose which course of action to take and the tax consequences will be based on the course of action chosen and not on the alternative choices which could have been made"* (SARS, 2016a:12).[16]

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[16] It should be borne in mind that SARS may attack these alternative structuring options in terms of the general anti-avoidance provisions of sections 80A to 80L of ITA or argue that such transaction(s) are simulated.

From the above, it is clear that IN94 is not intended to be a general principle-based guidance document. IN94 only addresses transactions that broadly align with the facts that gave rise to the dispute in the Ackermans case (see chapter 4).

It is not clear why SARS limited the scope of IN94 to this extent. In my view this is a missed opportunity for SARS to comprehensively set out its policy position and views regarding the assumption of contingent liabilities, and in particular in respect of the three broad structuring alternatives listed in chapter 3.

5.2 Embedded statutory obligations, free-standing contingent liabilities and valuation provisions

SARS, in IN94, distinguishes between the following:

(a) Embedded statutory obligations (Embedded Obligations)

Contingent liabilities that have an impact on the market value of an asset to which they are inextricably linked, and which asset is separately recognised for tax purposes. These Embedded Obligations must be transferred from the seller to the purchaser under law or by government regulation and will have an impact on the market value of the relevant asset (SARS, 2016a: 4).[17]

(b) Separately identifiable free-standing contingent liabilities (Free-standing Contingent Liabilities)

Contingent liabilities that are distinct existing obligations which are separately identifiable and are not embedded in an asset that is separately recognised for tax purposes. These contingent liabilities do not have an impact on the market value of assets individually recognised for tax purposes. Employee-related provisions such as

[17] SARS is of the view that contingent liabilities which are not required to be transferred by law or government could be embedded in individual assets recognised for tax purposes, this will however ultimately depend on the particular facts, and the onus is on the relevant taxpayer to show that the contingent liabilities are inextricably linked to an individual asset. Should this be the case the term "Embedded statutory obligation" is arguably a misnomer.

bonus provisions and post-retirement medical aid provisions rank as Free-standing Contingent Liabilities (SARS, 2016a: 4).

(c) Valuation provisions (Valuation Provisions)

Valuation provisions may be raised in the accounting records if prevailing circumstances indicate that the value of an asset is impaired. Such impairment will however not result in the incurral of expenditure on the part of a taxpayer for income tax purposes (SARS, 2016a: 3).

SARS is of the view that accounting provisions, as addressed in chapter 2, could constitute Embedded Obligations, Free-standing Contingent Liabilities, Valuation Provisions or a combination of the aforementioned, and it is therefore necessary to interrogate the reasoning for raising the relevant accounting provisions (SARS, 2016a: 4 – 5).

The Embedded Obligations concept was borrowed from a judgment of the Supreme Court of Canada in the *Daishowa-Marubeni International Ltd v Canada* matter (Daishowa judgment). SARS is of the view that in appropriate circumstances the principles pertaining to Embedded Obligations, as set out the in the Daishowa judgment, may find application in the South African context (SARS, 2016a: 3). BPR 308, addressed in Chapter 4, is the first reported advance ruling in which SARS applied this concept.

It is not clear on what basis SARS determined it necessary to introduce this distinction between Embedded Obligations and Free-standing Contingent Liabilities, and there is uncertainty whether the South African courts will accept this distinction. In addition, IN94 introduced concepts such as "individual assets recognised for tax purposes" and "inextricably linked to an individual asset" as conditions, all of which have not been tested by South African courts.

Notwithstanding the above, IN94 is only concerned with the income tax treatment of assumed Free-standing Contingent Liabilities.

5.3 The position of the seller

SARS is of the view that two questions fall to be addressed in respect of a seller:

(i) Question 1: Determination of the nature of the asset sold and the amount that must be included in gross income as defined in section 1(1) of the ITA or proceeds as contemplated in paragraph 35 to the Eighth Schedule; and

(ii) Question 2: If the seller is entitled to a deduction of the amount of the Free-standing Contingent Liability?

(SARS, 2016a: 6)

(a) Question 1 – gross income and/or proceeds

In respect of the first question, SARS proposes a two-pronged test. The first prong being the determination of the amount received by or accrued to the seller by virtue of the benefit of being relieved of the obligation to settle the Free-standing Contingent Liabilities, if and when the Free-standing Contingent Liabilities become unconditional (SARS, 2016a: 6 – 7).

The second prong relates to the nature of the asset to which the amount is allocated, and which will dictate whether the receipt or accrual of such amount is to be included in gross income or proceeds (SARS, 2016a: 7).

The term "amount" is not defined for the purpose of the ITA and it is therefore necessary to consider case law addressing the term. IN94 focusses on the judgment in *CSARS v Brummeria* case, which sets-out that the term "amount" should be interpreted widely and that:

(i) the receipt or accrual of a right in a form other than money that cannot be turned into money does not mean that the receipt or accrual of the right has no money value; and

(ii) an objective test is to be applied to determine whether the receipt or accrual has a monetary value,

(SARS, 2016a: 6 – 7).

SARS concedes that the determination of the amount of the benefit received can be difficult, but states that it must be determined objectively, based on arm's length principles of valuation and having regarding to the particular facts and circumstances and the intentions of the parties. The onus of proving the appropriateness of the amount determined is on the taxpayer (SARS, 2016a: 7).[18]

SARS further states that the amount of the benefit will be equal to the amount of the Free-standing Contingent Liability which has been negotiated and agreed by the seller and the purchaser, and as stated in the agreement of sale, i.e. the face value of the agreed amount, and which may differ from the face value of the contingent liability recorded in the accounting records of the seller (SARS, 2016a: 7).[19] The determination of the amount of the benefit is to take place at the earliest of the receipt or accrual by the seller, and the provisions of the sale agreement are important in this regard (SARS, 2016a: 8).[20]

If in substance and form no value has been placed on the assumption of Free-standing Contingent Liabilities, there is no additional amount of consideration. SARS caveats the latter by stating that if in substance a value is placed on the assumption of a Free-standing Contingent Liability, but in form the agreement does not reflect the agreed value, or understates the value, there will be an additional amount of consideration (SARS, 2016a: 8).

Questions regarding whether or not a taxable benefit will be received by the seller have not been raised before. This was not relevant in the Ackermans case or any of the BPRs until BPR 308, which appears to have been guided by IN94.

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18 It is unclear to which taxpayer SARS is referring, i.e. the seller or the purchaser.

19 The amount must not be discounted to its present value based on the fact that payment(s) by the purchaser, if any, will only be made in future (SARS, 2016a: 7).

20 In this regard conditions precedent are of particular relevance, and which may affect the timing of when the seller becomes unconditionally entitled to the benefit.

From the seller perspective it would appear that this added complication may have the effect that should a seller fail in putting forth a convincing argument that it paid the purchaser to assume the relevant contingent liabilities, or as in the Ackermans case, accepted a lower purchase price, SARS may contend that a taxable benefit was received by or accrued to the seller. This potential dichotomy of outcomes does not make commercial, business or economic sense.

(b) Question 2 – Deductions in respect of the Free-standing Contingent Liabilities

This requires an evaluation of the intended deduction in light of requirements of the General Deduction Formula, however SARS follows the example of the Cloete JA in the Ackermans *Ltd v CSARS*, by only focusing its inquiry into whether a seller incurred expenditure or suffered a loss by assuming the Free-standing Contingent Liabilities (SARS, 2016a: 9).

SARS is of the view that it is unnecessary to discuss the other elements of the General Deduction Formula, as in the absence of satisfying all the elements of the General Deduction Formula, the taxpayer will not qualify for a deduction under section 11(a) of the ITA (SARS, 2016a: 9).

This inquiry, in my view, is misplaced, and especially as it is common cause that a seller will not qualify for a deduction under section 11(a) of the ITA by virtue of the purchaser assuming contingent liabilities (whether Embedded Obligations or Free-standing Contingent Liabilities) only.

A seller, as was the case in the Ackermans case,[21] will be well advised to argue that expenditure of an amount equal to the amount of the contingent liabilities was incurred to rid itself of the contingent liabilities or to acquire an indemnity in respect of the relevant contingent liabilities. I.e., the seller may argue that by virtue of the sale agreement it incurred expenditure by transferring the assets constituting the going concern in exchange for the purchase price consideration which may include an indemnity in respect of its contingent

[21] Please refer to the critique of the Ackermans judgment in chapter 4.

liabilities. It is therefore not relevant whether or not expenditure had been incurred in respect of the contingent liabilities and/or if contingent liabilities had materialised.

This failure to consider these alternative constructions and all of the elements of the General Deduction Formula is, with respect, an oversight by SARS.

5.4 Position of the purchaser

From the purchaser's perspective, the purchaser would ideally want to be entitled to a deduction in terms of section 11(a) or capital allowances in terms of sections 11(2), 12C or 13 for example (SARS, 2016a: 13).

Accordingly, the following factors are important:

(i) the date of the sale (SARS, 2016a: 13);

(ii) the date on which the Free-standing Contingent Liabilities become unconditional (SARS, 2016a: 13); and

(iii) the nature of the particular asset(s) acquired and to which the Free-standing contingent liabilities are allocated,

(SARS, 2016a:16).

(a) Date of sale

In an inquiry into a purchaser's entitlement to an income tax deduction or an allowance, the particular asset acquired and the relevant provisions of the ITA in terms of which the deduction or allowance is claimed must be considered (SARS, 2016a: 13).

SARS states that various sections of the ITA under which a taxpayer may wish to claim a deduction or an allowance refer to terms such as "expenditure incurred", "expenditure actually incurred", "cost incurred" or "cost", as one of the requirements for the deductibility of an amount (SARS, 2016a: 13). In respect of a taxpayer's cost of acquisition of an asset,

SARS is of the view that it generally requires the incurral of expenditure, and the relevant allowance must be calculated based on the expenditure incurred (SARS, 2016a: 13).

The next question is thus to what extent the purchaser has incurred expenditure in respect of Free-standing Contingent Liabilities assumed at the date of the sale?[22] SARS points out that the form of the consideration will impact on the availability of deductions and allowances (SARS, 2016a: 14).

In the case of the assumed Free-standing Contingent Liabilities, SARS states that at the date of the sale it will not be known whether, and if so, to what extent the assumed Free-standing Contingent Liabilities will materialise, and be settled by the purchaser. Although the purchaser has undertaken to incur expenditure should the Free-standing Contingent Liabilities materialise, the purchaser cannot be said to have incurred expenditure in respect of the assumed Free-standing Contingent Liabilities at the date of the sale (SARS, 2016a: 14).

(b) Date on which the Free-standing Contingent Liabilities become unconditional

SARS holds the view that on the date on which the Free-standing Contingent Liabilities become unconditional, that:

> *"[t]he expenditure has arisen as a direct result of the purchaser's assumption of the free-standing contingent liability which was assumed as a means of settling the purchase price payable for the assets acquired. It was an undertaking between the purchaser and the seller. Accordingly, in determining the capital or revenue nature of the expense, the nature of the particular asset acquired must be ascertained."* [underlined own emphasis] (SARS, 2016a: 16).

The overarching consideration will thus be to which asset the Free-standing Contingent Liabilities are allocated in terms of the purchase price allocation. According to SARS such expenditure arose directly as a result of the purchaser assuming the relevant Free-standing Contingent Liabilities in order to discharge the purchase price of the assets acquired (SARS,

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22 It is assumed that the "date of sale" will be the effective date of the relevant sale agreement.

2016a: 16). For example, the fact the expenditure is incurred in respect of employment-related contingent liabilities such as leave pay provisions or bonus provisions, is of no consequences (SARS, 2016a: 15 – 16). SARS relies on a judgment by Her Majesty's Most Honourable Privy Council (Privy Council) in the *Commissioner of Inland Revenue v New Zealand Forest Research Institute Ltd* matter, to support its view. This approach has not been tested in South African courts.

Clegg has a contrarian view, and states that in his view the purchase of a business cannot be an overriding factor in determining causation and that the inherent nature of the expenditure incurred in or resulting from that purchase of the going concern must be taken into account, when determining the tax consequences (Clegg, 2010b).

The effect of SARS approach in respect of fixed assets and trading stock can be illustrated with the following examples:

(i) Fixed assets with a purchase price of R100 which is settled by the purchaser paying cash of R60 and assuming Free-standing Contingent Liabilities of R40. The capital allowance deductible in respect of the assets will potentially only be calculated based on the R60, which is expenditure actually incurred at the date of the sale.[23]

    SARS holds the views that the purchaser will potentially quality for an additional allowance if and when the relevant Free-standing Contingent Liabilities materialise, and the purchaser incurs expenditure (SARS, 2016a:14).

    In respect of assets that would have qualified for an allowance in respect of Free-standing Contingent Liabilities assumed in an earlier year of assessment but for the fact that such Free-standing Contingent Liabilities had not yet materialised, SARS holds the view that the allowance which is claimed in the year of assessment that the Free-standing Contingent Liabilities materialises must be adjusted to take into account the allowance(s) which would have been claimable in such earlier years of assessment (SARS, 2016a:17).

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[23] This is subject to the taxpayer satisfying the requirements of the provisions of the ITA in terms of which the relevant capital allowance is claimed.

This effectively allows for a mechanism whereby the allowances that would have been claimed in prior years of assessment are claimed in the year of assessment that the Free-standing Contingent Liabilities become unconditional.

(ii) In the case of trading stock with a purchase price of R100 which is settled by the purchaser paying cash of R60 and assuming Free-standing Contingent Liabilities of R40. The cost price for the trading stock for the purposes of sections 11(a) and 22 of the ITA will be R60, which is actually incurred at the date of the sale.

SARS recognises that the relevant Free-standing Contingent Liabilities may materialise, and the attendant section 11(a) deduction may arise in a year of assessment following the year of assessment in which the relevant trading stock is sold (SARS, 2016a: 17).

SARS concedes that the purchaser can assume Free-standing Contingent Liabilities without it being consideration for any particular asset acquired (SARS, 2016a:18). In this regard the deductibility will depend on the expenditure resulting from the Free-standing Contingent Liabilities materialising and meeting the requirements of the General Deduction Formula (SARS, 2016a: 19 – 20).

From an administrative perspective the purchaser will have to maintain separate records to "track-and-trace" the Free-standing Contingent Liabilities assumed and the assets to which same were allocated as well as the allowances and deductions claimed.

5.5 Special dispensation for transactions subject to the Corporate Rules

Although SARS does not address each of the Corporate Rules transactions separately, the following general principles will be applied by SARS to transactions subject to corporate roll-over relief in terms of the Corporate Rules:

(i) *"The principles for deductibility discussed in this Note apply equally in these circumstances."*;

(ii) *"... to the extent that the relief in sections 42 to 47 applies to the assets acquired, the expenditure that is incurred by the transferee when the free-standing contingent liability materialises must be evaluated within the context of the nature of the going concern business as carried on by the transferor before the transfer and by the transferee after the transfer."*;

(iii) *"In making such an evaluation no regard must be had to the fact that the assumption of the contingent liabilities by the transferee was part of the consideration for the acquisition of the assets."*; and

(iv) *"The circumstances under which the free-standing contingent liability arose in the hands of the transferor as well as the transferee must therefore be taken into account in determining the deductibility of the expenditure."*,

(SARS, 2016a:19).

The above represents a confirmation by SARS of the approach it adopted in respect of the assumption of the contingent liabilities in respect of transactions subject to the Corporate Rules in the past, and as set-out in BPRs 185 and 266 (see chapter 4).

In broad strokes, and based on the examples illustrated by SARS in IN94, the transferee, i.e. the purchaser, will "step into the shoes" of the transferor, i.e. the seller, in respect of the contingent liabilities. The nature of the expenditure which may result from the assumed contingent liabilities will not be transmuted based on the assets acquired by the purchaser, as is the case with transactions not subject to the Corporate Rules.

The abovementioned approach is welcomed, but it must be noted that in respect of the sale of a going concern that is only partially done in terms of the Corporate Rules,[24] there will be a discrepancy between the income tax treatment of assets transferred in terms of the Corporate Rules and assets transferred outside of the Corporate Rules. This adds another layer of complexity to the structuring and implementation of these transactions.

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[24] This may be as a result of an election by the relevant transferor and the transferee that the relevant Corporate Rules section does apply or the transaction, or part thereof, or assets transferred that do not quality for corporate roll-over relief under the Corporate Rules.

5.6 Legal status of IN94

Interpretation notes are issued by SARS, and in terms of section 1 of the TAA constitute "official publications". Section 5(1) of the TAA set out that an "official publication" will also constitute a "practice generally prevailing" in respect of the ITA.
The legal effect of this is *inter alia* that:

(i) SARS's scope to settle disputes regarding the income tax treatment of assumed consistent liabilities is constrained. In terms of sections 145 and 146 of the TAA, it may be inappropriate and not to the best advantage of the State if the settlement would be contrary to law or a "practice generally prevailing" and no exceptional circumstances exist to justify a departure from the law or practice; and

(ii) SARS's powers to issue additional assessments and reduced assessments may, in terms of section 99(a) of TAA be limited based on the application of IN94, i.e. a "practice generally prevailing".

(Strauss, 2018: 3)

This may be problematic as SARS is now required, and expected, to apply the principles formulated and set out in IN94.

Notwithstanding the above, the position is still that interpretation notes are not binding on the courts or taxpayers, and only constitute persuasive explanations in relation to the interpretation and application of statutory provisions (*CSARS v Marshall NO*, 2017: para [33]).

The Constitutional Court, per Froneman J, held in respect of the use of SARS interpretation notes following:

> *"Why should a unilateral practice of one part of the executive arm of government play a role in the determination of the reasonable meaning to be given to a statutory provision? It might conceivably be justified where the practice is evidence of an impartial application of a custom recognised by all concerned, but not where the*

practice is unilaterally established by one of the litigating parties. In those circumstances it is difficult to see what advantage evidence of the unilateral practice will have for the objective and independent interpretation by the courts of the meaning of legislation, in accordance with constitutionally compliant precepts. It is best avoided." [underlined own emphasis] (*Marshal and Others v CSARS*, 2018: para [10]).

Based on the analysis in this chapter and the uncertainties highlighted in the preceding chapters, it is clear that in respect of the taxation of assumed contingent liabilities there is no "custom recognised by all concerned". It is therefore questionable whether IN94 will be of any assistance to SARS should a dispute regarding same be decided by a court.

5.7 Conclusion

While IN94 does provide valuable insights into how SARS will address Free-standing Contingent Liabilities, questions must however be raised regarding the desirability of distinguishing between Free-standing Contingent Liabilities and Embedded Obligations.

Arguments for and against income tax deductions by the seller and purchasers, have been canvased in dissertations preceding this study, and all point to the critical conclusion that there are many unanswered questions. SARS has failed to address section 24C of the ITA in IN94. While SARS has indicated clear preferences in IN94, it must be noted that the findings by a court of law in future may bring the current practice and conduct by SARS into question.

Sellers and purchasers may request an advance ruling regarding the income the tax treatment of specific contingent liabilities intended to be assumed as part of the sale of a going concern, and this may include the classification of the contingent liabilities in terms of the conventions set out in IN94. However, having regard to the quality of the advance rulings discussed in chapter 4, and SARS's policy position, as set out in IN94, I submit that it is difficult to predict how SARS will approach such a request.

Although it is accepted that the income tax consequences for one party, whether the seller or the purchaser, will not have an impact on that of the other party, IN94 seems to imply that SARS is willing to entertain a situation which may lead to asymmetrical income tax results

for the parties to these transactions, and which disregards the economic consequences for sellers and purchasers. It therefore necessary to evaluate whether legislative reforms may be better suited to address this and other uncertainties.

It is worth reiterating that the purpose and scope of IN94 is limited to the assumption of Free-standing Contingent Liabilities assumed in the settlement or part settlement of the purchase price of a going concern, and is thus of limited use to parties who intend to employ alternative structuring options.

6. LEGISLATIVE REFORMS

It has been stated that there is no equity about a tax (*Cape Brandy Syndicate v Inland Revenue Commissioner*). Leach JA in *Adventure Shelf 122 (Pty) Ltd v CSARS* confirmed the following:

> *"... even if in certain instances it may seem 'unfair' for a taxpayer to pay a tax which is payable under a statutory obligation to do so, there is nothing unjust about it. Payment of tax is what the law prescribes, and tax laws are not always regarded as 'fair'. The tax statute must be applied even if in certain circumstances a taxpayer may feel aggrieved at the outcome."* (*New Adventure Shelf 122 (Pty) Ltd v CSARS*, 2017: para [28]).[25]

Hefer JA in *Cactus Investments (Pty) Ltd v CIR* held that:

> *"However, it is often said (cf ITC 268 7 SATC 169 at 163) that there is no equity in tax legislation (nor, I would add, complete rationality)… The taxpayer's remedy is to arrange his affairs, so far she is able, so as not to attract these results"* (*Cactus Investment (Pty) Ltd v CIR*, 1999: 322 – 323).

Based on the conclusions drawn from chapters 4 and 5, it is difficult and possibly impossible for sellers and purchasers to structure a sale of going concern so as not to attract unfair or inequitable income tax results for both parties in respect of the taxation of assumed contingent liabilities. The divergent views regarding the nature and effect of these transactions, the application of the ITA and the potential for absurd income tax consequences only serve to compound any potential unfairness and inequity. The suitability of the ITA, in its current form, for addressing the taxation of assumed contingent liabilities as part of the sale of a going concern can therefore is questioned.

The legislature is empowered to remedy the *status quo* by amendments to the ITA, and this chapter sets out an analysis of certain provisions and amendments which were proposed in the *Draft Taxation Laws Amendment Bill* of 2011 and the desirability for the introduction of a system of group taxation as possible remedies.

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[25] Also see *Commissioner for Inland Revenue v Simpson* 1949 (4) SA 678 (A) at 695.

6.1 Legislative intervention – General provisions

During the 2011 taxation legislative amendment cycle, Treasury proposed the introduction of two new provisions to the ITA, i.e. clauses 11F and 24CA (the Proposed Clauses), and various other amendments to the ITA.

The Proposed Clauses dealt with the income tax consequences that would flow from the assumption of contingent liabilities as part settlement of the purchase price of a going concern, and addressed the income tax consequences for sellers and purchasers.

The Proposed Clauses and further amendments provided for the following:

(a) Income tax consequences for the seller

Clause 11F dealt with the "*Deduction of contingent liabilities discharged as part of disposal of going concern*", and provided that where, in terms of any transaction, a seller disposes of a business undertaking as a going concern to a purchaser and:

(i) The seller is, in terms of that transaction, partially or fully relieved of any contingent liability as a result of the assumption of that contingent liability by the purchaser;

(ii) the consideration payable by the purchaser in terms of that transaction has been determined by the seller and the purchaser after taking into account the assumption of the contingent liability by the purchaser; and

(iii) the contingent liability relates to that business undertaking,

the fair market value of that contingent liability must, on the date of that disposal and for the purposes of determining the taxable income derived by the seller from carrying on a trade, be deemed to be an amount of expenditure actually incurred in the production of the income of the seller derived from trade.

In addition to clause 11F, amendments to the section 1(1) "gross income" definition and paragraph 35(1) were proposed.

(b) Income tax consequences for the purchaser

From the purchaser's perspective, clause 24CA was proposed to deal with the *"Inclusion and allowance in respect of contingent liabilities assumed as part of acquisition of going concern"*.

Clause 24CA(1) provided that where, in terms of any transaction, a purchaser acquires a business undertaking as a going concern from a seller and—

(i) that seller is, in terms of that transaction, partially or fully relieved of any contingent liability of that seller as a result of the assumption of that contingent liability by the purchaser;

(ii) the consideration payable by the purchaser in terms of that transaction has been determined by the seller and the purchaser after taking into account the assumption of the contingent liability by the purchaser;

(iii)the contingent liability relates to that business undertaking,

the fair market value of that contingent liability must be included in the income of the purchaser for the year of assessment during which that disposal is made.

The effect of this clause 24CA(1) would have been to include the fair market value of the contingent liability in the income of the purchaser, in the year of assessment in which the disposal was made.

Clause 24CA(2) provided that where during any year of assessment, an amount is included in the income of the purchaser in terms of clause 24CA(1) by virtue of the assumption by the purchaser of a contingent liability as contemplated in that sub-clause, any expenditure of the purchaser in respect of that contingent liability that is likely to be incurred by the purchaser in a future year of assessment must be allowed as a deduction for the year of assessment in which it is so included if, but for the contingency, it would have been allowed as a deduction in that year of assessment.

Clause 24CA(3) provided that the amount that is allowed as a deduction from the income of the purchaser in any year of assessment in terms of 24CA(2) must be deemed to be an amount received by or accrued to that person in the following year of assessment.

In addition to clause 24CA, the following amendments, were proposed:

(i) The addition to section 22(3)(a) of the ITA, dealing with the determination of the cost price of trading stock, the following subparagraph:

> *"(iv) include the fair market value of any contingent liability that—*
>
> *(aa) is assumed by that person as part of the acquisition of that trading stock; and*
>
> *(bb) relates to that trading stock, to the extent of that assumption."*

(ii) Amendment of paragraph 20(1)(a) of the Eighth Schedule, dealing with the determination of the base cost of assets, by the substitution in subparagraph (1) for item (a) of the following:

> *"(a) the expenditure actually incurred in respect of the cost of acquisition or creation of an asset, including the fair market value of any contingent liability that*
>
> *(i) is assumed as part of the acquisition of an asset;*
>
> *(ii) relates to that asset, to the extent of that assumption;"*

(c) Summary of the Proposed Clauses and amendments

The proposed legislative amendments and their intended effects can be summarised as follows:

Table 2 – Draft Bill – Summary of Proposed Clauses and Amendments

Party	Provision	Intended effect
Seller		
	Clause 11F	Deductions from the income of the seller of the fair market value of the contingent liabilities assumed by the purchaser, if the purchase price consideration

		payable by the purchaser is determined after taking into account the assumed contingent liabilities.
	Amendment to section 1(1) "gross income"	Inclusion of the fair market value of the contingent liabilities assumed by the purchaser in the gross income of the seller by virtue of being relieved from same.
	Amendment to paragraph 35(1) of the Eighth Schedule (proceeds)	Inclusion of the fair market value of the contingent liabilities assumed by the purchaser in the proceeds of the seller by virtue of being relieved from same.
Purchaser		
	Clause 24CA(1)	Inclusion of the fair market value of the contingent liabilities in the income of the purchaser, if the purchase price consideration payable by the purchaser is determined after taking into account the assumed contingent liabilities.
	Clause 24CA(2)	Allowance based on the expenditure in respect of the assumed contingent liabilities that are likely to be incurred by the purchaser in a future year of assessment must be allowed as a deduction.
	Clause 24CA(3)	The amount allowed as a deduction in terms of the 24CA(2) in the prior year must be must be deemed to be an amount received by or accrued to the purchaser in the following year of assessment.
	Amendments to section 22(3)(a) of the ITA	Inclusion of the fair market value of contingent liabilities assumed in the determination of the cost price of trading stock acquired by the purchaser.
	Amendments to paragraph 20(1)(a) of	Inclusion the fair market value of contingent liabilities assumed in the determination of the base cost of

	the Eighth Schedule	assets acquired by the purchaser.

(d) Comments regarding the proposed legislative amendments

Although the Proposed Clauses and the amendments were not in their final form, or properly refined, they would in effect have allowed for a more fair and equitable solution to certain of the problems outlined in this study, and:

(i) The seller would have been allowed a deduction from its income of the amount of the fair market value of the contingent liabilities assumed and taken into account in the determination of the consideration payable to it.[26]

(ii) The purchaser would have been required to include the value fair market value of the contingent liabilities in its income. However, clauses 24CA(2) and 24CA(3) would have allowed for relief in the form of an allowance for "future deductible expenditure" and the amendment to section 22 of the ITA and paragraph 20 of the Eighth Schedule would have allowed the purchaser include the fair market value of the contingent liabilities in the cost price of trading stock and/or in the determination of the base cost of assets, depending of the nature of the asset to which the contingent liabilities are allocated.

Problems with the Proposed Clauses and the proposed amendments include the following:

(i) No definition for the term "fair market value" was proposed – This would arguable have to be "fair value" as for the purposes of the financial reporting standards.

(ii) No clarity was provided as to whether the amounts incurred by the parties could still be regarded as being of a capital nature;

[26] A distinction must be drawn between the amount by which the purchase price consideration was reduced as result of the assumption by the purchaser of the contingent liabilities and the fair market value of the contingent liabilities, which may not be the same.

(iii) There is a risk that the seller may become entitled to deductions that it ordinarily would not have been entitled to, e.g. damages claims that would not have been deducible, etc.

(iv) There is potential for abuse if the Corporate Rules and the Proposed Clauses were to be used together – e.g. accelerated deductions for the seller in respect of contingent liabilities assumed coupled with corporate roll-over relief in respect of the assets transferred.

(v) The purchaser will have to "track-and-trace" the value of the contingent liabilities for accounting and income tax purposes, as the amounts may not necessarily be the same.

(vi) The terms "going concern" and "business undertaking" are used interchangeably in the draft Bill. It is unclear what the difference between the two concepts is.

It is interesting to note that the proposed income tax treatment in terms of the Proposed Clauses and the amendments, as proposed by Treasury, differ from the income tax treatment as set out in IN94. There appears to be a difference of opinion between Treasury and SARS.

6.2 Legislative intervention – Introduction of a system of group taxation

Although group taxation for South Africa has been considered,[27] and recommended, at various points in time, South Africa currently does not have a system of group taxation (DTC, 2018: 74). South African tax resident companies are subject to tax separately as stand-alone entities (Dachs: 2017, 148).

According to the International Bureau of Fiscal Documentation (IBFD), a system of group taxation refers to:

[27] The Margo Commission of Inquiry into the Tax Structure of the Republic of South Africa (1987), the Katz Commission of Inquiry into Certain Aspects of the Tax Structure of South Africa and the Davis Tax Committee.

Group treatment – *"special tax rules applicable to members of a group of companies under which the group is broadly assimilated – to a greater or lesser extent – for tax purposes to a single company."* (IBDF, 2019: "Group Treatment").

Dachs, in his article regarding the possibility of group taxation in the South African context, holds the view that distortions in the taxation of corporate groups may arise in the following circumstances:

(i) if conflicts exists between business structures and efficient tax measures; and

(ii) if functional equivalent corporates structures are afforded inconsistent tax treatment,

(Dachs, 2017: 148 – 149).

There are four main models of group taxation regimes (DTC: 2018, 67), and which include the following two systems.

(i) **Consolidation system** (also referred to as a fiscal unity system) – A corporate group is treated as one single entity for tax purposes by combining the profits and losses of the group and consolidating the treatment of other tax attributes; and

(ii) **Loss transfer system** (also referred to as a group relief system) – Under this system the companies will retain their separate identities for the purposes of taxes, however the transfer of losses to profit-making group companies is permitted,

(Dachs, 2017: 149).

Of the two systems, the Consolidation system appears to be the best suited to addressing the taxation of assumed contingent liabilities, and as the separate identities of sellers and purchasers forming part of the same consolidated group can be disregarded for the purposes of determining the income tax treatment of assumed contingent liabilities.

The formulation and implementation of a system of group taxation is a significant undertaking, and may include radical amendments to the ITA and the re-education of tax practitioners (Dachs, 2017: 151).

The movement towards a system of group taxation should ideally be undertaken as part of a broader policy paradigm by Treasury and Parliament. For this reason it may be inappropriate to develop and implement a system of group taxation only for the purpose of resolving the uncertainties regarding the taxation of assumed contingent liabilities. Furthermore, group taxation will be of no assistance in respect of the taxation of contingent liabilities assumed outside of the context of a consolidated group of companies.

The Davis Tax Committee in its *Report on The Efficiency of South Africa's Corporate Income Tax System* expressed its preference for a Loss transfer system, if a system of group taxation is introduced in South Africa (DTC, 2018: 78). This system, in my view, will be of little assistance in the resolution of the problems identified in this study.

6.3 Statutory interpretation

A further question is whether statutory interpretation may be of assistance.

Wallis JA in *Natal Joint Municipal Pension Fund v Endumeni Municipality* summarised the approach to be adopted in respect of the interpretation of legislation, other statutory instruments and contracts as follows:

> *"The present state of the law can be expressed as follows. Interpretation is the process of attributing meaning to the words used in a document, be it legislation, some other statutory instrument, or contract, having regard to the context provided by reading the particular provision or provisions in the light of the document as a whole and the circumstances attendant upon its coming into existence."*

> *"Whatever the nature of the document, consideration must be given to the language used in the light of the ordinary rules of grammar and syntax; the context in which the provision appears; the apparent purpose to which it is directed and the material known to those responsible for its production."*

"Where more than one meaning is possible each possibility must be weighed in the light of all these factors. The process is objective not subjective. A sensible meaning is to be preferred to one that leads to insensible or unbusinesslike results or undermines the apparent purpose of the document."

"Judges must be alert to, and guard against, the temptation to substitute what they regard as reasonable, sensible or businesslike for the words actually used. To do so in regard to a statute or statutory instrument is to cross the divide between interpretation and legislation. In a contractual context it is to make a contract for the parties other than the one they in fact made."

"The 'inevitable point of departure is the language of the provision itself', read in context and having regard to the purpose of the provision and the background to the preparation and production of the document."

[underlined and line breaks own emphasis] (*Natal Joint Municipal Pension Fund v Endumeni Municipality,* 2012: para [18]).

These interpretation rules will apply to the ITA, and should arguably be used to motivate for common sense businesslike solutions where contingent liabilities are assumed.

Corbett CJ in *CIR v Nemojim (Pty) Ltd* held that:

"It has been said that "there is no equity about a tax". While this may in many instances be a relevant guiding principle in the interpretation of fiscal legislation, there is nevertheless a measure of satisfaction to be gained from a result which seems equitable, both from the point of view of the taxpayer and from the point of view of the fiscus. And it may be fairly inferred that such a result is in conformity with the intention of the Legislature." [underlined own emphasis] (*CIR v Nemojim (Pty) Ltd*, 1983: 958)

It can be argued that in appropriate circumstances equity does have an important role to play in achieving outcomes that are equitable from the point of view of taxpayers and from the

point of view of the fiscus (The Taxpayer, 2017: 2), and the above interpretation rules may also aid in this regard.

6.4 Conclusion and the way forward

According to the OECD the ideal tax system should be neutral and equitable between different forms of business activities. A neutral tax system treats similar economic activities in similar ways for tax purposes, so that decisions are based on economic merits and not on tax consequences (OECD, 2014: 30). The Davis Tax Committee is also of the view that neutrality diminishes the negative effect of taxation on corporate decisions based on resource allocation (DTC, 2018: 70 – 71).

In is my view, the principle of neutrality, in the context of assumed contingent liabilities, would require that regard must be had for the income tax treatment of both the seller and the purchaser in order to promote a degree of symmetry regarding the income tax consequences.

Clegg, in his article analysing the judgment of Wallis J in *ITC 1839*, and setting out his views regarding the purchaser's position, is of the view that there is no reason why the tax treatment of expenditure in the hands of one party should not affect the tax treatment of an accrual in the hands of another party (Clegg, 2010b).

I am also of the view that should comprehensive legislative reforms be adopted, that the abovementioned policy considerations must be taken into account by Treasury and Parliament. A principle-based solution should also be preferred over a rule-based solution such as the Corporate Rules of the ITA, which have been criticised for being overly mechanical and inflexible (DTA, 2018: 56). The Accounting Standards, as discussed in chapter 2, must also be considered.

The rules of statutory interpretation as set out in *Natal Joint Municipal Pension Fund v Endumeni Municipality* allow the court to have regard to the abovementioned policy considerations in appropriate situations. Notwithstanding the latter, it is my submission that appropriate legislative reforms should be adopted.

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7. CONCLUSION AND RECOMMENDATIONS FOR FURTHER STUDIES

7.1 Conclusion

This study addresses the income tax treatment of contingent liabilities assumed as part of the sale of a going concern and the uncertainties for sellers and purchasers. The objective of this study was to analyse IN94 and guidance documents published by SARS in order to determine whether the uncertainties can be resolved by the issuance and refinement of these policy documents or whether legislative reforms are required,

The nature and classification of contingent liabilities for the purposes of the ITA and financial reporting standards were analysed and compared. It was found that the Accounting Standards and how taxpayers account for provisions and contingent liabilities for accounting purposes; have an impact on the purchase price of a going concern and may influence how the purchase price consideration is constituted and settled. SARS and taxpayers consider the distinction relevant and important. The inherent mismatches between the treatment of contingent liabilities for the purposes of the ITA and financial accounting standards were listed.

In chapter 3 certain general structuring considerations that must be taken into account when publications by SARS, case law and the ITA are considered were presented. Importantly, the three structuring options available to sellers and purchasers were highlighted. The findings in chapters 4 and 5 suggest that SARS's BPRs and IN94 may be of little assistance in respect of the evaluation of the income tax consequences that may flow from the different structuring alternatives.

It was found that IN94 failed to comprehensively clarify the position, and in particular the limited scope and purpose of IN94 and the introduction of legal concepts borrowed from foreign jurisdictions added to the uncertainties. Due to the divergent views regarding the income tax treatment of assumed contingent liabilities, and as evidenced by the work of various writers, it is unlikely that the courts will rely on IN94.

Finally, in chapter 6 the legislative additions and amendments proposed in the draft Taxation Laws Amendment Bill of 2011, as well as the introduction of a system of group taxation were

considered. It was found that the legislative additions and amendments proposed in the draft Bill required refinement and that the introduction of a system of group taxation would be inappropriate if introduced only to address certain of the uncertainties highlighted in this study.

In conclusion, it is my view that the uncertainties regarding the taxation of contingent liabilities assumed as part of the sale of going concern can only be resolved by means of legislative reforms. The rules of interpretation as set out by the Constitutional Court in *Natal Joint Municipal Pension Fund v Endumeni Municipality* and the *Appellate Division in CIR v Nemojim (Pty) Ltd* can serve as a check to ensure that interpretations that are "*sensible" and* not *"unbusinesslike" are* advanced.

Treasury and SARS will be well advised to take cognisance of principles such as tax neutrality and the ideal to strive for tax symmetry in respect of the tax treatment of assumed contingent liabilities in the hands of sellers and the purchasers. Fairness and equity should be overarching guidance principles.

7.2 Recommendations for further studies

In prior studies the following have been considered:

(i) The tax consequences for a seller (and comments on the perspective of the purchaser) when contingent liabilities are transferred (Rossouw: 2010); and

(ii) The tax deductibility of contingent liabilities transferred in the sale of a going concern (Jacobs: 2012).

It is submitted that questions regarding the income tax consequences for sellers and purchasers have been exhausted, and yet this study found that there remain various divergent views. It is unlikely that unanimity will be reached.

Therefore a study focused on the investigation of what possible frameworks and policies for the income tax treatment of assumed contingent liabilities may entail should be performed.

This could possibly include policy considerations such as neutrality, efficiency and simplicity, effectiveness, fairness and flexibility to guide the development of a solution.

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9. ANNEXURE A – EXTRACTS FROM THE DRAFT TAXATION LAW AMENDMENT BILL OF 2011

Amendment of section 1 of Act 58 of 1962

7. (1) Section 1 of the Income Tax Act, 1962, is hereby amended—

…

(n) by the substitution in the definition of "gross income" for paragraphs (i) and (ii) following paragraphs:

"(i) in the case of any resident, the total amount**[,]** (in cash or by way of partial or full relief from any liability of such resident or otherwise**[,]**) received by or accrued to or in favour of such resident: Provided that, where the amount is received by or accrued to or in favour of such resident by way of relief from any liability of such resident and that liability is contingent, that total amount must be limited to the fair market value of that liability; or

(ii) in the case of any person other than a resident, the total amount**[,]** (in cash or by way of partial or full relief from any liability of such person or otherwise**[,]**) received by or accrued to or in favour of such person from a source within **[or deemed to be within]** the Republic: Provided that, where the amount is received by or accrued to or in favour of such person by way of relief from any liability of such person and that liability is contingent, that total amount must be limited to the fair market value of that liability,".

Insertion of section 11F in Act 58 of 1962

36. (1) The Income Tax Act, 1962, is hereby amended by the insertion after section 11E of the following section:

"**Deduction of contingent liabilities discharged as part of disposal of going concern**

11F. Where, in terms of any transaction, a person disposes of a business undertaking as a going concern to a purchaser and—

(a) that person is, in terms of that transaction, partially or fully relieved of any contingent liability of that person as a result of the assumption of that contingent liability by that purchaser;

(b) the consideration payable by the purchaser in terms of that transaction has been determined by that person and that purchaser after taking into account the assumption of the contingent liability by that purchaser; and

(c) the contingent liability relates to that business undertaking, the fair market value of that contingent liability must, on the date of that disposal and for the purposes of determining the taxable income derived by that person from carrying on a trade, be deemed to be an amount of expenditure actually incurred in the production of the income of that person derived from trade.".

Amendment of section 22 of Act 58 of 1962

49. (1) Section 22 of the Income Tax Act, 1962, is hereby amended—

…

(b) by the addition to subsection (3)(a) of the following subparagraph:

"(iv) include the fair market value of any contingent liability that—

(aa) is assumed by that person as part of the acquisition of that trading stock; and

(bb) relates to that trading stock,

to the extent of that assumption.".

Insertion of section 24CA in Act 58 of 1962

53. (1) The Income Tax Act, 1962, is hereby amended by the insertion after section 24C of the following section:

"**Inclusion and allowance in respect of contingent liabilities assumed as part of acquisition of going concern**

24CA. (1) Where, in terms of any transaction, a person acquires a business undertaking as a going concern from a seller and—

(a) that seller is, in terms of that transaction, partially or fully relieved of any contingent liability of that seller as a result of the assumption of that contingent liability by that person;

(b) the consideration payable by the person in terms of that transaction has been determined by that seller and that person after taking into account the assumption of the contingent liability by that person;

(c) the contingent liability relates to that business undertaking, the fair market value of that contingent liability must be included in the income of that person for the year of assessment during which that disposal is made.

(2) Where, during any year of assessment, an amount is included in the income of a person in terms of subsection (1) by virtue of the assumption by that person of a contingent liability as contemplated in that subsection, any expenditure of that person in respect of that contingent liability that is likely to be incurred by that person in a future year of assessment must be allowed as a deduction for the year of assessment in which it is so included if, but for the contingency, it would have been allowed as a deduction in that year of assessment.

(3) The amount that is allowed as a deduction from the income of a person in any year of assessment in terms of subsection (2) must be deemed to be an amount received by or accrued to that person in the following year of assessment.".

Amendment of paragraph 20 of Eighth Schedule to Act 58 of 1962

117. (1) Paragraph 20 of the Eighth Schedule to the Income Tax Act, 1962, is hereby amended—

(a) by the substitution in subparagraph (1) for item (a) of the following item:

"(a) the expenditure actually incurred in respect of the cost of acquisition or creation of an asset, including the fair market value of any contingent liability that

(i) is assumed as part of the acquisition of an asset;

(ii) relates to that asset,

to the extent of that assumption;"; and

Amendment of paragraph 35 of Eighth Schedule to Act 58 of 1962

118. (1) Paragraph 35 of the Eighth Schedule to the Income Tax Act, 1962, is hereby amended by the substitution for subparagraph (1) of the following subparagraph:

"(1) Subject to subparagraphs (2), (3), and (4), the proceeds from the disposal of an asset by a person are equal to the total amount (in cash or by way of partial or full relief from any liability of that person or otherwise) received by or accrued to or in favour of, or which is treated as having been received by, or accrued to or in favour of, that person in respect of that disposal, and includes—

[(a) the amount by which any debt owed by that person has been reduced or discharged; and]

(b) any amount received by or accrued to a lessee from the lessor of property for improvements effected to that property:

Provided that, where the amount is received by or accrued to or in favour of a person by way of relief from any liability of that person and that liability is contingent, that total amount must be limited to the fair market value of that liability.".