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UNIVERSITY OF CAPE TOWN



The tax deductibility of contingent liabilities transferred in the sale of a going concern

By

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DECLARATION

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With God, nothing is impossible.

Without God, I would never have been able to achieve what I have. I honour Him for gracing me with the abilities that He has entrusted in me and for always keeping me in His perfect peace.

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GLOSSARY OF TERMS

AFS	Annual Financial Statements
BCR	Binding Class Ruling
2011 DTLAB	Draft Taxation Laws Amendment Bill, 2011
the Act	Income Tax Act (No. 58 of 1962, as amended)
IAS 19	International Accounting Standard 19: Employee Benefits
IAS 37	International Accounting Standard 37: Provisions, Contingent Liabilities and Contingent Assets
IFRS 3	International Financial Reporting Standard 3: Business Combinations
SARS	South African Revenue Service

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1 Introduction and overview

1.1 Background and rationale for the study

The debate around the deductibility of transferred contingent liabilities, when a business is sold as a going concern has been raging for many years with no definitive guidance provided in legislation¹ and limited court decisions on the issue, with the exception of the recent *Ackermans Ltd v CSARS*² (“*Ackermans case*”) judgment and BCR 029 issued by SARS.

Generally, when selling a business, either the shares in the company or the net assets (ie total assets less liabilities) of the business are sold. The former brings about a change in shareholders, whereas the latter, also known as the sale of a going concern, results in the transfer of assets and liabilities between the seller and purchaser. The challenge which arises, specifically, from the sale of the net assets, is that the tax deductibility of accounting provisions and contingent liabilities may be problematic.

Recognising provisions is essentially a prudent accounting mechanism to shield a business from the consequences of potential future expenses and losses. Therefore, when AFS are perused, it is more likely than not, that there will be some form of provision or contingent liability³ recognised or disclosed, respectively, and these can easily run into millions of Rands in large businesses.

IAS 37⁴ defines an accounting provision as a liability of uncertain timing and amount. For accounting purposes, provisions are recognised in the statement of financial position with a corresponding expense recognised in the statement of comprehensive

¹ Other than the recently proposed legislative amendments in the Draft Taxation Laws Amendment Bill, 2011 which has subsequently been withdrawn

² *Ackermans Ltd v Commissioner of South African Revenue Services* (2010) 73 SATC 1

³ Contingent liabilities have a different meaning for accounting and tax purposes, as will be analysed later in this study.

⁴ International Accounting Standard 37: Provisions, Contingent Liabilities and Contingent Assets. 1 July 1999

income,⁵ which implies that the expenses related to these provisions are deducted for accounting purposes in the period in which the provision is recognised.

Accounting contingent liabilities, on the other hand, are possible obligations dependent on the happening of some uncertain future event(s). Contingent liabilities, i.e. possible obligations, are not recognised for accounting purposes, but do require appropriate disclosure in the AFS.

Nonetheless, the fact that expenditure in respect of recognised accounting provisions is deductible for accounting purposes does not mean that deductions may also be claimed for tax purposes. Therefore, the tax legislation should be given due consideration in this instance.⁶

It is common cause that, from a tax perspective, accounting provisions or contingent liabilities are not deductible, as they are by their very nature conditional upon the happening of some uncertain future event and, consequently, not actually incurred,⁷ which is one of the requirements that must be met in order for an expense to be deductible in terms of the “general deduction formula”, as encompassed in section 11(a) read together with section 23(g) of the Act. To the extent that the uncertain future event materialises, the expenditure will be deductible, if the balance of the requirements of the general deduction formula are met. In addition, section 23(e) of the Act specifically prohibits the deduction of any provision or an amount transferred to a reserve unless the Act specifically provides for it.

However, the issue that has been debated, and which has been the cause of many further questions, is whether a deduction may be claimed, and more importantly, who may claim the deduction in respect of accounting provisions/contingent liabilities of a seller which are in existence, at the time of the sale of a going concern, and which are transferred to a purchaser.

⁵ Unless the obligation incurred gives access to future economic benefits or assets.

⁶ *Sub-Nigel v Commissioner for Inland Revenue* (1948) 15 SATC 381

⁷ *Nasionale Pers Bpk v Kommissaris van Binnelandse Inkomste* (1986) 48 SATC 55

In the recently decided *Ackermans* case (*supra*), the court only considered the first element of the general deduction formula, namely, whether the seller had “expenditure” or “expenditure actually incurred” in respect of the accounting contingent liabilities assumed by the purchaser. The court held that “expenditure incurred” means the undertaking of an obligation to pay or the actual incurring of a liability.⁸ Therefore, based on the facts of the *Ackermans* case (*supra*), the court found that expenditure was not actually incurred by the seller, as no obligation was created in terms of *that* agreement of sale for the seller to pay the purchaser for assuming its accounting contingent liabilities.⁹ Consequently, the seller was not afforded the deduction. However, the court pronounced in an *obiter dictum* that there would be no restriction to the purchaser deducting the contingent liabilities in due course, as and when they became unconditional.¹⁰

Apart from the issue at hand, i.e. the tax deductibility of accounting provisions and contingent liabilities in the situation where a business is sold as a going concern, the above case also demonstrates the importance of the drafting of a sale agreement, as it has been criticised that much of the lower court’s decision hinged on the construction of the agreement (Ger 2009). It is submitted that the same reliance was placed on the sale agreement in the SCA, as would generally be the case.

The SCA has, thus, (based on the facts of the *Ackermans* case (*supra*)) shed some light on one of the aspects to consider in respect of the treatment of transferred accounting provisions and contingent liabilities from the seller’s perspective i.e. that the seller cannot claim a deduction in respect of the contingent liabilities transferred to the purchaser if it does not have a liability to do so or actually incurred expenditure. However, it is clear, as will be seen from the research objectives of this study, that there are still many unanswered questions in this area and a need for legislative intervention or guidance.

⁸ At paragraph 8.

⁹ The lower court, however, addressed all aspects of the general deduction formula in *Income Tax Case No. 1839* (2009) 72 SATC 61.

¹⁰ At paragraph 9.

In May 2011, SARS issued BCR 029 which deals with the question as to whether the buyer, when buying the assets and liabilities of another company within the same group of companies in terms of section 44 of the Act, will be entitled to deduct the contingent liabilities (accounting provisions) taken over from the seller, when these are actually incurred. The ruling made in respect of the proposed transaction was that the purchaser will be entitled to deduct the expenditure actually incurred which relates to contingent obligations assumed, when the uncertain future events in respect of the contingencies materialises. Consequently, the seller was not afforded any deduction in respect of these contingent liabilities. It is submitted that this is a narrow application under corporate rules and does not give general guidance.

Subsequent to the *Ackermans* case (*supra*), BCR 029 and perhaps as a result of the above (a practice not entirely unusual in the context of drafting legislation in South Africa), on 23 February 2011 during his 2011 Budget Speech, the Minister of Finance announced that new legislation would be introduced to clarify the position of the seller and purchaser in relation to contingent liabilities when a business is sold as a going concern. In due course, on 2 June 2011, the 2011 DTLAB was published for comment and included the much anticipated proposed legislative amendments in respect of the above. Essentially, the proposed amendments acknowledged the need for clarification of the tax treatment of transferred/assumed contingent liabilities when determining the total consideration of a business sale and the deductibility of the contingent liabilities so transferred/assumed; and aimed to – in the words of the Explanatory Memorandum to the 2011 DTLAB – “remove the uncertainty.”¹¹

However, due to the fact that different views exist as to which party should be entitled to the deduction; in a Draft Response Document from National Treasury and SARS on the 2011 DTLAB, the Standing Committee on Finance noted that the proposed

¹¹ Paragraph 3.5 of the Explanatory Memorandum on the 2011 DTLAB

legislative amendments should be withdrawn and that a general binding ruling or an interpretation note should be released to clarify the treatment.¹²

Therefore, as the law currently stands, we are yet to receive legislative intervention or definitive guidance on the subject matter of this study.

1.2 Research objectives

Following from the above background and recent developments it is submitted that the subject of this study is historically and commercially a pertinent concern. This study, therefore, aims to address the following main research question:

“When contingent liabilities are transferred to a purchaser, in the sale of a business as a going concern, who may claim the tax deductions: the seller, purchaser or neither?”

In order to assess the above research question, this study will address the following sub-questions:

- a) Whether the seller may be able to claim deductions on the basis that the seller has essentially transferred assets (cash or otherwise) to the purchaser in order for the purchaser to settle the accounting provisions or contingent liabilities on the seller’s behalf. Therefore, the provisions or contingent liabilities may be said to be realised in the hands of the seller i.e. the seller has paid the purchaser (through the transfer of assets) to assume the liabilities (contingent or otherwise)).

More simply, does the transfer of an asset (if appropriately worded in the contract) represent or amount to the incurral of expenditure in relation to the provision or contingent liability in question. For example, has an asset been transferred to settle, for example, a bonus provision, (which could be viewed to have been incurred in the production of the seller’s income and would not have been of a

¹² Draft Response Document from National Treasury and SARS on the Taxation Laws Amendment Bill, 2011.

capital nature as it was accumulated as a result of employing staff who generated income for the seller in the current and preceding years); and

- b) If the above is not the case, the issue is then whether the purchaser, when it in due course discharges and settles the accounting provisions or contingent liabilities, can at that stage claim such payment as a deduction. The challenge, however, would be the fact that no part of the income arising during the time that the accounting provision or contingent liabilities were originally raised, was ever included in the taxable income of the purchaser. Therefore, the expenditure defrayed by the purchaser would not be incurred in the production of income.

In addition, it needs to be considered whether a contingent liability was assumed by the purchaser as part of the purchase price in order to acquire the assets, which would infer that the settlement of such provision is capital in nature, and hence not deductible.

Further questions which will be addressed, includes:

- What if the seller actually made a payment to the purchaser for taking over the contingent liabilities?
- What if the agreement specifies that the purchaser will pay a specified amount for the assets and assume the liabilities for another specified amount which is payable by the seller, and by set-off the net purchase price is paid by the purchaser?
- If it can be successfully argued that expenditure was actually incurred (by either party), what about the remaining requirements of the general deduction formula i.e. whether expenditure was actually incurred in the production of income, not of a capital nature and laid out or expended for purposes of trade?

Further to the above, despite the fact that the 2011 DTLAB proposed amendments have been withdrawn, it is submitted that the withdrawn amendments could be seen to be the SARS' view or at least one of its views on the matter, which provides

taxpayer's with useful insight into the 'mind' of the SARS. For that reason, this study will also include a brief analysis of these withdrawn amendments and its desired result as was enunciated in the Explanatory Memorandum to the 2011 DTLAB.

1.3 Methodology

In order to address the research objective set out above, this study will primarily be based on:

- A review of currently effective accounting standards and current tax legislation, as it relates to the definitions and treatment of provisions and contingent liabilities from both an accounting and a tax perspective, including the tax deductibility thereof, when it is transferred to a purchaser of a business as a going concern; and
- A critical analysis of case law, specifically in relation to the general deduction formula. This analysis will be supported by judicial commentaries and writings of experts on the area.

1.4 Limitations on the scope of the study

The current study is not intended to propose draft legislation for South Africa.

The tax implications of the transfer of *only* assets (i.e. not linked to the transfer of liabilities), as it relates to the sale of a business as a going concern, are specifically excluded from the scope of this study, which focuses on liabilities.

Furthermore, the sale of businesses as a going concern, outside South Africa will not be included in this study.

1.5 Structure of the study

The accounting definitions and treatment of provisions and contingent liabilities, including the treatment thereof when a business is sold as a going concern, is reviewed in Chapter 2 of this study.

Chapter 3 reflects on the definition of contingent liabilities for tax purposes and the tax treatment thereof; and focuses on an analysis of case law in relation to the general deduction formula as it pertains to the deductibility of expenditure, and includes an analysis of specific case law involving the transfer of accounting provisions and contingent liabilities in the sale of a going concern. This analysis will create the platform for Chapter 4, wherein the research questions will be addressed.

Chapter 5 is dedicated to a brief review of the recent proposed amendments to tax legislation on the deductibility of contingent liabilities in the hands of the seller and purchaser, which have subsequently been withdrawn, *albeit* to be included in a future interpretation note or binding general ruling.

Conclusions and recommended areas for future research are contained in Chapter 6.

2 Liabilities, provisions and contingent liabilities from an accounting perspective

2.1 Introduction

The accounting comprehensive income (commonly known as net profit before tax) reflected in a company's statement of comprehensive income is generally the amount utilised in the tax computation as the basis for calculating the company's taxable income for a particular year of assessment. To this figure i.e. comprehensive income, the differences between the accounting and tax treatment of particular items of expenditure and income will be adjusted for in order to reflect the income on which tax is payable by the company in respect of the year of assessment (i.e. taxable income).

One of factors to be considered when determining the tax treatment of business transactions (whether separately disclosed in the AFS or not) is the accounting nature and treatment of these transactions. Thus, before analysing the treatment of provisions or contingent liabilities from a tax perspective, the accounting nature and treatment of these items are discussed in this chapter.

2.2 Liabilities

At the base of any accounting provision or contingent liability (as will be addressed below) there is a fundamental link with a 'liability'.

IAS 37 defines a liability 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.”¹³ (emphasis added)

¹³ At paragraph 10

2.2.1 Present obligation

The event that gives rise to the present obligation is any occurrence which results in a *legal or constructive* obligation of payment for the entity, so that the entity has no other realistic alternative to settling that amount.¹⁴

(It should be noted that, for tax purposes, only legal obligations may give rise to liabilities – whether conditional or not.)

Legal obligation

A legal obligation is one that is derived from a contract (either from their explicit or implicit terms), from legislation, or from the operation of law.¹⁵

A contract, for example, a deed of sale in the case of property, usually gives rise to legal obligations for the contracting parties. The passing of legislation which requires, for example, that certain environmental damages that have already been caused by parties in a specific industry be rectified, could also give rise to a legal obligation. However, in the latter instance the obligation will only arise once the law becomes operative.¹⁶ A warranty given by a manufacturer at the time a sale is made is also an example of a legal obligation (PricewaterhouseCoopers LLP 2007).

Constructive obligation

On the other hand, where an entity has created a valid expectation of other parties that it will discharge certain responsibilities as a result of the actions of the entity itself, for example, by an established pattern of past conduct, corporate policies or a specific current statement, a constructive obligation is derived.¹⁷

Retailers that have a policy of giving cash refunds to dissatisfied customers, whether or not the goods they bought are faulty, is an example of a constructive obligation as

¹⁴ *Ibid*

¹⁵ *Ibid*

¹⁶ IAS 37 paragraph 22

¹⁷ IAS 37 paragraph 10

this is the retailers' established or published practice (PricewaterhouseCoopers LLP 2007).

2.2.2 Past event

A past event, which triggers a present obligation, is required in order for a liability to exist. The past event is known as the 'obligating event' which is defined as an event that creates a legal or constructive obligation that results in an entity having no realistic alternative to settling that obligation.¹⁸

In the example of warranties (above), the obligating event would be the original sale or in the case of land contamination where there is an obligation (legal or constructive) to restore certain environmental damage, the obligating event would be the original contamination of the land.

The 'no realistic alternative' requirement, implies that if there is a realistic possibility that the entity can avoid settlement, no obligation would arise. In terms of paragraph 17 of IAS 37, an entity has no realistic alternative to settling an obligation only where the settlement of the obligation can be enforced by law or the event, in the case of a constructive obligation, creates a valid expectation on others that the entity will discharge the obligation.

2.2.3 Outflow of economic resources

In essence, the future settlement of a liability (i.e. a present obligation as a result of a past event) should result in the outflow of economic resources from the entity.

2.3 Provisions

Where an entity has a "*liability of uncertain timing or amount*" an accounting provision may have to be accounted for. Therefore, in order to recognise a provision, the entity must first have a liability, as discussed above.

¹⁸ *Ibid*

The fundamental difference between a liability and a provision is the degree of uncertainty in respect of the amount or timing of the payment. Consequently, there is a clear distinction between provisions and, for example, trade payables which arise as a result of an entity having received goods or services from a supplier that have been invoiced or contractually agreed to and where the amount and timing of payment is certain.¹⁹

Provisions should also be distinguished from accruals which are essentially a category of liabilities to pay for goods or services received or supplied that have not yet been invoiced or confirmed with the supplier.²⁰ For example, with the receipt of telecommunications services it is expected that an entity could, at the end of the month, make a reasonable estimate of its telecommunications usage for the past month by using the entity's level of productivity for that month and previous months' statements of account. In this case, the amount could be said to be almost certain and the timing would be expected to be within a few days after month-end or at the next month-end (if payments are to be made at month-end). It is therefore clear that, with an accrual the degree of uncertainty is slightly more than that associated with a trade payable but, most definitely, much less than that associated with a provision (PricewaterhouseCoopers LLP 2007).

Once the uncertainty in respect of the outcome of a provision is removed, the provision will become a normal payable or creditor (PricewaterhouseCoopers LLP 2007).

Employee benefits are specifically excluded from the scope of IAS 37.²¹ However, IAS 19²² requires an entity to recognise a liability for accumulating compensated absences or leave, which is typically earned by employees as they provide services,²³ if certain requirements are met. Briefly, IAS 19 requires that a liability for, for

¹⁹ IAS 37 paragraph 11(a)

²⁰ IAS 37 paragraph 11(b)

²¹ Paragraph 5(d) of IAS 37

²² IAS 19: Employee Benefits. 1 January 1999

²³ IAS 19 paragraph 13

example, leave pay be recognised if the following requirements are satisfied (Sacho 2009):

- The employer has an obligation to compensate employees for future absences attributable to employees' services already rendered;
- The obligation relates to rights that accumulate from period to period;
- It is probable that the amount will be paid; and
- A reliable estimate can be made of the amount of the obligation.

If the liability arising from accumulated leave pay should be recognised as an accrual in the accounts, due to more certainty in respect of timing and/or amounts to be paid out, and not as a provision, due to less certainty in respect of the timing and/or amounts to be paid out, there would be no specific disclosure requirements necessary for the leave pay accrual, which would be included as part of "trade and other payables" in the statement of financial position (Sacho 2009).

It may be argued that the *definition* of a 'provision' in terms of IAS 37, i.e. a liability of uncertain timing or amount does not preclude liabilities which fall outside the scope of IAS 37. Thus even though leave pay is a liability of uncertain timing or amount that is scoped out of IAS 37, it is still a 'provision', *albeit* measurable under IAS 19, as it meets the definition of a provision in IAS 37.

As the above recognition criteria in respect of short-term employee benefit liabilities provided for in IAS 19 may be said to be very similar to the recognition criteria set-out in IAS 37 (discussed below), no further analysis of the IAS 19 requirements will be addressed in this study.

2.4 Recognition criteria of provisions

Paragraph 14 of IAS 37 provides that a provision should only be recognised if:

- an entity has a present obligation as a result of a past event;

- it is *probable* that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- a *reliable estimate* can be made of the amount of the obligation.

As the concepts of a ‘present obligation’ and a ‘past event’ have been outlined above, the requirements of a probable outflow of economic resources and a reliable estimate of such outflow are discussed below.

2.4.1 Probable outflow of economic benefits

The term ‘probable’ is taken to mean ‘more likely than not’. The phrase ‘more likely than not’ means that, the probability that the event will occur is greater than the probability that it will not.²⁴ Consequently, where there is a probability of more than 50 percent that an outflow of economic resources may occur, a probable outflow may be said to exist (PricewaterhouseCoopers LLP 2007).

2.4.2 Reliable estimate

In terms of paragraph 25 of IAS 37 an entity will, in almost all instances, be able to make a *reliable estimate* of an obligation which may be used to recognise a provision, for accounting purposes.

2.5 Contingent liabilities

In contrast to provisions, an accounting contingent liability is either 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, discussed above as:
 - the economic outflow of resources is *not* probable or

²⁴ IAS 37 paragraph 23

- the amount of the obligation *cannot* be reliably estimated.²⁵

Contingent liabilities are not recognised for accounting purposes but are required to be disclosed in the AFS, unless the likelihood of an outflow of economic resources is remote.²⁶

An example of a contingent liability, for accounting purposes, which is required to be disclosed in the AFS, would be in the instance of a court case where legal proceedings are instituted against Company X, and Company Y is seeking damages from Company X but Company X disputes its liability. If, at the end of the first financial year-end of Company X, it is advised by its legal team that it is probable that it will not be found liable for damages, no provision is recognised and the matter is disclosed as a contingent liability, unless the probability of an outflow of economic resources is remote. However, should new developments occur before the end of the second year, and Company X is advised by its legal team that it is now probable that it will be found liable for damages, a provision should be recognised.²⁷

Following from the definition of a contingent liability and the above example, once the uncertainty in respect of the outcome (in relation to a possible obligation) is clarified, or the probability of an outflow of economic resources or a reliable estimate is made (in relation to a present obligation), the contingent liability will become a provision and may be recognised as such. Consequently, the expenditure relating to the provision will be deducted for accounting purposes as discussed above.

Based on the above understanding of the accounting treatment of provisions and contingent liabilities and considering the objective of this study, the question which comes to mind is what the accounting treatment of these items would be when a business is sold as a going concern.

²⁵ IAS 37 paragraph 10

²⁶ IAS 37 paragraphs 27 and 28

²⁷ Example 10A of IAS 37

2.6 Accounting treatment of provisions and contingent liabilities in the sale of a going concern

In terms of IFRS 3²⁸, a purchaser of a business should recognise the assets acquired and liabilities assumed at their acquisition-date fair values and disclose information in their AFS that enables users to evaluate the nature and financial effects of the acquisition. The IFRS, however, provides limited exceptions to the fair-value recognition and measurement principles.

With reference to accounting contingent liabilities, only those contingent liabilities assumed in a business combination that are a present obligation and can be measured reliably are recognised.²⁹ When these contingent liabilities are so recognised, no amounts are debited to the statement of comprehensive income, as it would form part of the initial acquisition journal entries. In general, any excess consideration paid for the business acquisition would be recognised as negative goodwill in the statement of comprehensive income.³⁰

Generally, a purchaser measures and accounts for assets acquired and liabilities assumed or incurred in a business combination, after the business combination has been completed, in accordance with other applicable IFRSs, for example, provisions should be accounted for in terms of IAS 37 as discussed above. Consequently, as a provision or contingent liability materialises subsequent to the business combination, the purchaser would settle the same, for example in cash (i.e. credit its bank account) and decrease the provision with a corresponding debit. Thus, no part of this assumed provision, which is subsequently settled, is claimed as a deduction in the statement of comprehensive income. However, any increase in the provision, subsequent to the acquisition date, would be recognised and, therefore, deducted by the purchaser by debiting the statement of comprehensive income, as discussed in terms of IAS 37 above.

²⁸ IFRS 3 introduction paragraphs IN1 to IN13

²⁹ IFRS 3 paragraph 47

³⁰ IFRS 3 paragraph 56

Similarly, from the seller's perspective the assets and liabilities disposed of, sold or transferred are derecognised in accordance with the relevant accounting standards.

In a simplistic example, where a company sells its business and it has a provision recorded in its books, the provision should be derecognised by debiting the provision account and crediting the statement of comprehensive income (which effectively reverses the provision) or bank (if the seller pays the purchaser an amount to assume the provision as part of the sale of the business as a going concern). In both instances (i.e. a credit to the statement of comprehensive income or bank), the seller does not deduct any portion of the provision as an expense for accounting purposes when the business is sold, as the deduction has already been claimed (for accounting purposes) when the provision was originally recognised and subsequently re-measured.

2.7 Conclusion

With the above background and understanding in respect of liabilities, provisions and contingent liabilities from an accounting perspective, the following chapter analyses the current tax treatment and implications of provisions and contingent liabilities.

3 Provisions or contingent liabilities from a tax perspective

3.1 Introduction

Following from Chapter 2 it is important to note that, the accounting treatment of a particular expense does not necessarily accord with the tax treatment thereof. Therefore, the provisions of the Act should be considered in determining the tax treatment. The court in *Sub-Nigel v CIR (supra)* made this very clear in its judgment, stating that:

“At the outset it must be pointed out 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 Act.”

The above case makes it clear that when deciding on the deductibility of amounts, it is not the accounting practices, but the wording of the Act that will be given due regard. However, as submitted in the previous chapter, understanding the accounting treatment assists with applying the correct tax treatment.

By way of an example, for accounting purposes, provisions for bonuses are generally deducted as an expense in the statement of comprehensive income. Thus, the accounting profit before tax would include an expense related to the bonus provision. For tax purposes, however, an expense cannot be deducted by a taxpayer unless the expense has, *inter alia*, been “actually incurred.” Provisions or contingent liabilities are generally considered not to be actually incurred expenditure, as there is no *unconditional* obligation at the end of the year of assessment, to settle the amount, as will be seen from the analysis which follows. Therefore, for tax purposes, the expense in respect of the bonus provision may be treated as non-deductible and should be added back in the tax computation. However, if the accounting treatment was not understood i.e. if it was not known whether the expense was deducted for accounting purposes or not, the add back of the expense could possibly be overlooked.

Provisions or contingent liabilities are not defined in the Act. The court in *CIR v Golden Dumps (Pty) Ltd*³¹, with reference to what constitutes a contingent or conditional obligation stated the following at pages 206 and 207:

*“A liability is contingent in that sense in a case where there is a claim which is disputed, at any rate genuinely disputed and not vexatiously or frivolously for the purposes of delay. In such a case the ultimate outcome of the situation will be confirmed only if the claim is admitted or if it is finally upheld by the decision of a court or arbitrator. **Where at the end of the tax year in which a deduction is claimed, the outcome of the dispute is undetermined, it cannot be said that a liability has been actually incurred.** The taxpayer could not properly claim the deduction in that tax year, and the receiver of revenue could not, in the light of the onus provision of s 82 of the Act, properly allow it.” (emphasis added)*

Thus, for tax purposes, a provision or contingent liability is generally considered to be a conditional liability, i.e. conditional upon the happening of some future event. Hence, any contingent liability raised by a taxpayer will generally not be deductible, for tax purposes, until such taxpayer incurs an obligation to unconditionally settle the amount. (A detailed analysis in respect of the application of the “general deduction” formula follows in paragraph 3.2 of this study).

It therefore follows that in order for the seller or purchaser to have a potential income tax deduction for expenditure incurred which may include the transfer or assumption of certain accounting provisions and contingent liabilities, it is required that the expenditure must, *inter alia*, be “*actually incurred*”.

Before addressing the research questions listed in paragraph 1.2, it is important to, at this stage, review the applicable provisions of the Act as well as the relevant case law in relation to the tax deductibility of expenditure.

³¹ *Commissioner for Inland Revenue v Golden Dumps (Pty) Ltd* (1993) 55 SATC 198(A) at page 204

3.2 The general deduction formula

In determining the taxable income of a taxpayer, the Act provides for a deduction of expenses either in terms of what is referred to as “the general deduction formula” or in terms of specific deductions set out in the Act. As there are currently, no specific deductions encompassed in the Act in respect of contingent liabilities in particular, the provisions of the general deduction formula are applicable when assessing the deductibility of the related expenditure.

The general deduction formula is contained in section 11(a) read with section 23 of the Act.

Section 11 of the Act provides as follows:

“For the purpose of determining the taxable income derived by any person from carrying on any trade, there shall be allowed as deductions from the income of such person so derived –

- a) expenditure and losses actually incurred in the production of income, provided such expenditure and losses are not of a capital nature;”*

Section 23 of the Act on the other hand provides as follows:

“No deductions shall in any case be made in respect of the following matters, namely -

- e) income carried to any reserve fund or capitalised in any way;*
- f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one;*
- g) any moneys, claimed as a deduction from income derived from trade, to the extent to which such moneys were not laid out or expended for the purposes of trade;”*

Following from the above, the general deduction formula comprises the following elements:

- expenditure and losses;
- actually incurred (during the year of assessment);
- in the production of income;
- laid out or expended in the course and for purposes of trade; and
- not of a capital nature.

Each element of the general deduction formula will be analysed below, with specific reference to relevant judicial precedents.

3.2.1 Expenditure and losses

The term “expenditure” is not defined in the Act. Accordingly, reference should be made to the ordinary dictionary meaning of the word, as it has not been defined by the South African courts.

The Oxford Online Dictionary (Oxford Dictionaries 2011) defines “expenditure” as:

“the action of spending funds; an amount of money spent; the use of energy, time or other resources”

From the dictionary meaning of ‘expenditure’ it is clear that the person incurring expenditure should actually spend an amount of money or resources.

Notwithstanding the lack of case law on the meaning of the word, there has however been some debate by the courts in differentiating between a “loss” and “expenditure” and it is submitted that the meaning of “expenditure” could be deduced by drawing a comparison with that of the word “loss”.

In *Joffe & Co (Pty) Ltd v CIR*³² the court considered that the word “loss” had several meanings. In the context of a provision almost identical to section 11(a) of the Act, the court held that its meaning was “somewhat obscure” and that it was not clear whether it meant anything different from “expenditure”. Watermeyer CJ, who delivered the judgment of the Appellate Division of the Supreme Court, said that:

“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.”

Although the then Appellate Division held that “expenditure usually means a voluntary payment of money” it is submitted that the word “expenditure” is not restricted to an outlay of cash but includes outlays of amounts in a form other than cash.³³

Summary

Therefore, for purposes of the general deduction formula, the word “expenditure” could be held to mean the voluntary payment or an obligation to pay cash or anything that has an ascertainable money value.

“Losses”, on the other hand, are involuntary deprivations.

3.2.2 Actually incurred

In determining whether a taxpayer may deduct an amount of expenditure or a loss (hereinafter collectively referred to as “expenditure”) from its gross income in terms of the general deduction formula, the next step is to consider whether the particular expenditure has been “actually incurred” in the year of assessment in which the deduction is sought.

³² *Joffe & Co (Pty) Ltd v Commissioner for Inland Revenue* (1946) 13 SATC 354

³³ *Caltex Oil (SA) Ltd v Commissioner for Inland Revenue* (1975) 37 SATC 1

Tax is assessed on an annual basis. In order for an expense to be deductible in a particular year of assessment, that expense must have been actually incurred during that particular year of assessment. In this regard, the Appellate Division case of *CIR v Golden Dumps (Pty) Ltd (supra)* stated the following in respect of the annual basis of assessing the taxability of a taxpayer:

“In Caltex Oil (SA) Ltd v Secretary for Inland Revenue 1975(1) SA 665(A) Botha JA referred at pp 673H to 674B to certain provisions of the Act (to which I shall return), and said at 674B-E:

*‘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...**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*).’ (emphasis added)*

From the above it is clear that it is only at the end of the year of assessment that a taxpayer can determine whether expenditure has been actually incurred during that year of assessment.

The well known case of *Port Elizabeth Electric Tramway Company Ltd v CIR*³⁴ held that the words of the statute are “actually incurred” and not “necessarily incurred”. The court held that the use of the word “actually” as contrasted with the word “necessarily” may widen the field of deductible expenditure and held the following in this regard:

³⁴ *Port Elizabeth Electric Tramway Company Ltd v Commissioner for Inland Revenue* (1936) 8 SATC 13 at page 15

“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.”

At page 15, the court went further to state that expenses “actually incurred” do not mean those expenses which have been “actually paid”; as long as the liability to make payment thereof has actually arisen, it may be deductible. It is submitted, however, that the fact that expenses were actually paid means that it was actually incurred.³⁵

The word “incurred” as held in *ITC 1587*³⁶ means the following:

“‘Incurred’ is not limited to defrayed, discharged or borne, but does not include a loss or expenditure which is no more than impending, threatened or expected.”

On appeal by Edgars Stores Ltd to the Appellate Division, the Appellate Division held that the lower court³⁷ had reached the correct conclusion in deciding whether or not expenditure has been incurred. In the lower court, the question of whether or not expenditure has been incurred was summarised by Ackermann J as follows:

“Another well-established principle, not challenged in this appeal, is that a distinction must be drawn between:

- a) *the case where the existence of the liability itself is **conditional and dependent upon the happening of an event after the tax year in question, in which event the liability is not incurred in the tax year in question; and***
- b) *the case where the existence of the liability is certain and established within the tax year in question, but the amount of the liability cannot be accurately determined at the tax year-end, in which event the liability is nevertheless regarded as having been incurred in the tax year in question.”*³⁸ (emphasis added)

³⁵ The deductibility of certain prepaid expenses are, however, limited by section 23H of the Act.

³⁶ *Income Tax Case No. 1587 (1994) 57 SATC 97 at page 103*

³⁷ *Commissioner for Inland Revenue v Edgars Stores Ltd (1986) 48 SATC 89 at page 94*

³⁸ In the case of paragraph (b) the expense would have to be estimated.

Corbett JA, as he then was, delivering the judgment of the majority of the Appellate Division in *Edgars Stores Ltd v CIR*³⁹ stated the following:

*“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 section 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).” (emphasis added)*

Closer to the topic of provisions or contingent liabilities addressed in this study, in the case of *Nasionale Pers Bpk (supra)*, the court had to decide whether the taxpayer’s provision for bonuses at year-end were deductible for tax purposes as having been “actually incurred” in that year of assessment. It is important to note, as in most instances regarding an assessment of the deductibility of expenditure, such a determination is dependent upon the facts of each case.

In this case, the taxpayer sought a deduction of its provision for staff bonuses in respect of its 31 March year-end, which bonuses were to be paid out on 30 September (i.e. 6 months later). The deductions were disallowed by the Commissioner on the grounds, to which the taxpayer objected, that such bonus provisions were not “actually incurred” for the purposes of the general deduction formula.

The bonus policy introduced by the taxpayer stated bonuses would only be payable to qualifying employees in the taxpayer’s employ on 31 October and that the full amount of the bonus would be reclaimed from any employee giving notice, after receipt of bonus, of intention to resign before 31 October. The practice of the taxpayer, based on

³⁹ *Edgars Stores Ltd v Commissioner for Inland Revenue* (1988) 50 SATC 81 at page 90

the evidence provided to the court, was to pay bonuses on 30 September while retaining the right to recover the bonus paid to an employee, if they were no longer in the service of the taxpayer on 31 October, or if a notice of resignation had been received before then.

In giving evidence, the taxpayer conceded that no employee could demand their bonus payment on 31 March (i.e. at year-end), however, it was stated that at 31 March the taxpayer had contractually bound itself to make payment of the bonuses and as such the bonuses were actually incurred within the meaning of section 11(a) of the Act. The taxpayer contended that the condition that the employees had to be in the employ of the taxpayer in 31 October in order to be eligible to receive the bonus was a resolute condition, in the sense that the liability existed and merely the passage of time governed the payment thereof and that the obligation ceased only if the employee's service was terminated voluntarily or by reason of his misconduct.

The taxpayer contended that the entire bonus pool would be distributed among its employees in the following year, and that the bonus provision was not linked to any single employee. Accordingly, the entire bonus provision should be seen as actually incurred as the entire amount would be paid out, irrespective of who the employee was that would receive that payment.

The court, in its judgment, reaffirmed the principle that, for purposes of section 11(a) of the Act, expenditure had to be "actually incurred" in that tax year in which the liability legally arose and not in the tax year in which actual settlement of the debt occurred.

The court held that in reality the taxpayer had concluded obligations with its employees on an individual basis and not collectively, and accordingly such obligations could not be lumped together. Cumulatively, the taxpayer's liability to its employees as a group was nothing more than the obligations which the taxpayer concluded with its individual employees.

The court, after concluding that the taxpayer had obligations to each of its employees individually, held further that it was unnecessary to decide whether the condition to pay the bonuses was suspensive or resolutive, and that the predominant fact was that the question as to whether the employee would be in the employ of the taxpayer at 31 October, was an uncertain future event. The question of whether the taxpayer had an unconditional legal obligation to pay the bonuses to its employees could only be answered on 31 October and not 30 September, or even 31 March. The court, accordingly, found in favour of the Commissioner as the provision for bonuses claimed as a deduction by the taxpayer were not “actually incurred” in the year of assessment in question.

On page 69, the court quoted with approval the Special Court decision in *ITC 969*⁴⁰, where it was held that the taxpayer had the onus of proving that it has incurred:

“... an absolute and unqualified legal liability”.

From an analysis of the above case law it is evident that for expenditure to be actually incurred during a year of assessment, the taxpayer must have incurred an absolute and unconditional legal obligation to pay an amount. Therefore, if the obligation is conditional upon the happening of an event, the taxpayer would not have incurred an absolute and unconditional legal obligation to pay the amount. Accordingly, the taxpayer in such instance would not have actually incurred the expenditure.

Section 23(e) of the Act can be said to be founded on the “actually incurred” requirement and principles addressed above, as it prohibits the deduction of a provision or an amount transferred to a reserve unless the Act specifically provides for it.⁴¹

In light of the law cited above, it appears to be trite law that the words “actually incurred” do not mean that expenditure must be due and payable at the end of the year

⁴⁰ *Income Tax Case No. 969 (1961) 24 SATC 777 at page 786*

⁴¹ In the case of section 11(j) of the Act i.e. provision for doubtful debts

of assessment. As long as there is a clear legal liability to pay at the end of the year, the expenditure is deductible even though actual payments may fall due only in a later year.

Summary

Bearing the above in mind, the following established principles can be extracted from the law relating to the term “actually incurred” in the context of section 11(a) of the Act:

- 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;
- Only expenditure 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 section 11(a) for income tax purposes;
- The obligation incurred may be unconditional *ab initio* or, though initially conditional, may become unconditional by fulfilment of the condition during the year of assessment; and
- Where the existence of the liability is certain and established within the tax year in question, but the amount of the liability cannot be accurately determined at the tax year-end, the liability is nevertheless regarded as having been “actually incurred” in the tax year in question. In this case the expense should be estimated for section 11(a) purposes and deducted in the year in which it was incurred.

3.2.3 In the production of income

In terms of the general deduction formula, read together with section 23(f) of the Act, any expenditure, which has not been incurred for the purpose of producing income (as defined in section 1 of the Act)⁴², will not be allowed as a deduction.

⁴² Gross income less exempt income

Based on an important dictum of Watermeyer CJ, in delivering the judgement of the Appellate Division in *New State Areas v CIR*⁴³, it was pointed out that “*expenditure and losses do not produce income*” but instead activities normally produce income and any related expenditure is merely a consequence of such activities. Therefore, the expenditure attendant upon such activities must be incurred in the production of income.

The above principle was established in *Port Elizabeth Electric Tramway Co Ltd (supra)*, where it was held at pages 16 and 17 that:

"The purpose of the act entailing the expenditure must be looked to. If it is performed for the purpose of earning income, then the expenditure attendant upon it is deductible... provided the act is bona fide done for the purpose of carrying on the trade which earns the income the expenditure attendant upon it is deductible."

Watermeyer AJP, as he then was, in the *Port Elizabeth Electric Tramway* case (*supra*) identified three types of expenditure in the production of income, which can be described as follows:

- 1) expenditure which is necessary for the performance of business operations;
- 2) expenditure which is attached to the business operations by chance; and
- 3) expenditure which is incurred voluntarily for the more efficient performance of such operations.

The tests referred to above were summarised in *COT v Rendle*⁴⁴, Appellate Division, Southern Rhodesia on page 330 as follows:

⁴³ *New State Areas v Commissioner for Inland Revenue* (1946) 14 SATC 155 at page 163

⁴⁴ *Commissioner of Taxes v Rendle* (1965) 26 SATC 326

“This broad test, which may now be regarded as the accepted standard test, is as follows:

All expenses attached to the performance of a business operation bona fide incurred for the more efficient performance of such operation provided they are so closely connected with it that it would be proper, natural or reasonable to regard the expenses as part of the cost of performing the operation”.

It is, furthermore, derived from the *Port Elizabeth Electric Tramway* case (*supra*) that the two questions, which must be asked to establish whether expenditure is incurred in the production of income, are:

- whether the act giving rise to the expenditure is performed for the purpose of earning income, and if so;
- whether the expenditure is linked so closely to the act that it may be regarded as part of the cost of performing it.

In *Joffe & Co (Pty) Ltd v Commissioner for Inland Revenue* (*supra*), the court held that if a deduction is to be granted, the act entailing the expenditure must be a “*necessary concomitant*” of the taxpayer’s trade.

A further principle to be applied in considering whether expenditure was incurred in the production of income was established in the case of *CIR v Nemojim (Pty) Ltd*⁴⁵, which was confirmed in the case of *CIR v Standard Bank of South Africa Ltd*⁴⁶, on page 196 as follows:

“Generally, in deciding whether moneys outlaid by a taxpayer constitute expenditure incurred in the production of the income (in terms of the general deduction formula) important and sometimes overriding factors are the purpose of the expenditure and what the expenditure actually effects...”

⁴⁵ *Commissioner for Inland Revenue v Nemojim (Pty) Ltd* (1983) 45 SATC 241

⁴⁶ *Commissioner for Inland Revenue v Standard Bank of South Africa Ltd* (1985) 47 SATC 179

In *Sub Nigel Ltd v CIR (supra)*, the Appellate Division held that expenditure incurred in the production of income does not mean that there can be no deduction unless income has been produced, but means that the expenditure must have been incurred for the purpose of earning income whether in the current or any future year of assessment.

Summary

The following principles emerge from the above analysis regarding the question of whether expenditure was incurred in the production of income:

- the purpose of the act giving rise to the expenditure as well as the purpose of the expenditure and what it actually effects must be considered in determining whether an expense was incurred in the production of income;
- it must be considered whether the expenditure incurred is so closely linked to the business operations of the taxpayer that it may be regarded as part of the cost of performing it. Expenditure incurred may be necessary for the performance of business operations, attached to it by chance or incurred voluntarily for the more efficient performance of such operations; and
- it is not necessary for income to have actually been produced in order for the attendant expenditure to be incurred in the production of income.

3.2.4 Laid out for the purposes of trade

In terms of section 23(g) of the Act, expenditure may only be deducted to the extent that it is incurred for the purposes of trade.

The term “trade” is defined in section 1 of the Act as:

“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..., or any design as defined..., or any trade mark as defined..., or any copyright as defined..., or any other property which is of a similar nature.”

In discussing the definition of “trade” in *Burgess v Commissioner for Inland Revenue*⁴⁷, the court held:

“That it is well-established that the definition of ‘trade’ should be given a wide interpretation...”

In this regard Grosskopf JA went on to cite the case of *ITC 770*⁴⁸, quoting favourably the judgment of Dowling J, who stated in relation to a similar definition of trade that it was

“...obviously intended to embrace every profitable activity and which I think should be given the widest possible interpretation”.

Section 23(g) of the Act has been described by Silke⁴⁹, at paragraph 7.11, as the negative requirement of the general deduction formula which prohibits, as a deduction from income, any moneys derived from trade, to the extent to which such moneys were not laid out or expended “wholly or exclusively for the purposes of trade”.

As discussed above, section 23(g) must be read together with section 11(a).

In *SIR v Ineson*⁵⁰ it was held:

“That whether or not the expenditure in issue constituted an allowable deduction in terms of s 23(g) of the Act was a question of law.”

In *Ticktin Timbers CC v CIR*⁵¹ at 401 Hefer JA held that:

“...the purpose for which the expenditure was incurred is the decisive consideration in the application of section 23 (g)”.

⁴⁷ *Burgess v Commissioner for Inland Revenue* (1993) 55 SATC 185(A)

⁴⁸ *Income Tax Case No. 770* (1953) 19 SATC 216

⁴⁹ De Koker, A.P. and Williams, R.C. 2011. *Silke on South African Income Tax*. (LexisNexis electronic version)

⁵⁰ *Secretary for Inland Revenue v Ineson* (1980) 42 SATC 125(A)

⁵¹ *Ticktin Timbers CC v Commissioner for Inland Revenue* (1999) 61 SATC 399

Silke (De Koker A.P. and Williams R.C. 2011) discusses the consideration by the United Kingdom courts of the words “expended for the purposes of trade” in section 23(g) of the Act stating that:

“the courts there have interpreted them to mean ‘for the purpose of enabling a person to carry on and earn profits in the trade’ or, in other words, ‘for the purpose of earning the profits ... the word ‘profits’ in this sense has a much wider meaning than ‘income’ as defined in section 1.”

Silke (De Koker A.P. and Williams R.C. 2011), at paragraph 7.3, is of the view that it is not a requirement of the general deduction formula that the taxpayer makes, or attempts to make, a profit in an “accounting” or “economic” sense. The taxpayer’s failure to do so, however may lead to the conclusion that the requirement of incurring expenditure “in the production of income” or for “the purposes of trade” have not been met. Silke’s view (De Koker A.P. and Williams R.C. 2011) is formulated on the judgement by Corbett JA, as he then was, in *De Beers Holdings (Pty) Ltd v CIR*⁵²:

*“It is true...that the absence of a profit does not necessarily exclude a transaction from being part of the taxpayer’s trade; and correspondingly moneys laid out in a non-profitable transaction may nevertheless be wholly or exclusively expended for the purposes of trade within the terms of section 23(g). **Such moneys may well be disbursed on the grounds of commercial expediency or in order indirectly to facilitate the carrying on of the taxpayers trade...Where however, a trader normally carries on business by buying goods and selling them at a profit, then as a general rule a transaction entered into with the purpose of not making a profit, or in fact registering a loss, must, in order to satisfy s 23(g), be shown to have been so connected with the pursuit of the taxpayers trade, e.g., on ground of commercial expediency or indirect facilitation of the trade, as to justify the conclusion that, despite the lack of profit motive, the moneys paid out under the transaction were wholly and exclusively expended for purposes of trade ...Generally unless the facts speak for themselves, this will call for an explanation from the taxpayer.”** (emphasis added)*

⁵² *De Beers Holdings (Pty) Ltd v Commissioner for Inland Revenue* (1986) 47 SATC 229

The determination of whether expenditure has been incurred for the purposes of trade will turn on the facts of the particular case.

In *Solaglass Finance Co (Pty) Ltd v CIR*⁵³, it was held that there are no hard and fast rules for deciding whether a taxpayer's expenditure falls within or outside of the ambit of section 23(g). It was further held that it was 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 the case of *CIR v Pick 'n Pay Wholesalers (Pty) Ltd*⁵⁴ the courts dealt with section 11(a) read together with section 23(g) and found certain expenditure (i.e. a donation) not to be in the taxpayer's trade. The facts were that a management company sought to deduct a donation it made to a charitable organisation called the "Urban Foundation" on the grounds that the donation was a form of "indirect advertising" for the company and therefore in the production of its income. The Commissioner for Inland Revenue contended that in terms of s 11(a) and 23(g) the expenditure was of a capital nature, not wholly or exclusively laid out for the purposes of trade and did not constitute expenditure incurred in the production of income. Nicholas AJ stated at page 150:

"Moreover there is the fact that the issue – whether the expenditure was exclusively for the purpose of trade but produced the incidental effect, or the secondary consequence, of benefit to the Urban Foundation, or whether it had the dual purpose of promoting trade and benefiting the Urban Foundation – is a narrow one, and the line difficult to draw. There is nothing in the record to suggest that the distinction was present to the mind of any one at the time of the donation, or that it was of any importance before the expenditure was disallowed by the Commissioner."

The majority held that the taxpayer did not show that it did not have philanthropic interest as well as a commercial interest, and that the appeal by the Commissioner should therefore succeed and that the expenditure was not deductible.

⁵³ *Solaglass Finance Co (Pty) Ltd v Commissioner for Inland Revenue* (1991) 53 SATC 1

⁵⁴ *Commissioner for Inland Revenue v Pick 'n Pay Wholesalers (Pty) Ltd* (1987) 49 SATC 132

It, therefore, seems clear that that if a taxpayer can prove to the Commissioner or a court that it had an intention to earn profits from its trade, then even in circumstances where it makes a loss; any expenditure incurred for the purpose of that trade will be deductible, barring that that other requirements of the general deduction formula are met.

Summary

Based on the case law and authorities, above, if it can be shown that expenditure was incurred for the purpose of earning profits, then such expenditure would be seen to be incurred for the purposes of its trade.

The purpose for which expenditure was incurred is of utmost importance when assessing its deductibility in terms of section 23(g), more so than the need or intention to actually make a profit. Naturally, the facts and circumstances of each case will need to be considered in making this assessment.

3.2.5 Not of a capital nature

The last of the requirements of the general deduction formula is that, in order for an amount of expenditure, which has been actually incurred in the production of income, to be deducted from the taxpayer's income, such expenditure must not be of a capital nature.

There is no definition in the Act of what constitutes "capital" expenditure. Despite the wealth of judicial precedents on the capital and revenue nature of expenditure, it is impossible to extract a universal test that will provide a "once-off" solution to the question.

It has been held by Innes CJ in *George Forest Timber Co Ltd*⁵⁵ that:

⁵⁵ *Commissioner for Inland Revenue v George Forest Timber Co Ltd* (1924) 1 SATC 20 at page 25

“In the absence of any authoritative and comprehensive definition of capital expenditure it is well to bear in mind the characteristic quality of capital; that it is wealth employed in creating fresh wealth, invested to produce income.”

The courts have, however, given guidelines as to the distinction between capital and revenue expenditure, some of which are discussed below.

Income-producing structure versus working of income-earning operations

With reference to a taxpayer “acquiring an income producing concern”, Innes CJ held, in *CIR v George Forest Timber Co Ltd (supra)*, at pages 25 and 26, that:

“... money spent in creating or acquiring an income-producing concern must be capital expenditure. It is invested to yield future profit; and while the outlay does not recur the income does. There is a great difference between money spent in creating or acquiring a source of profit, and money spent in working it. The one is capital expenditure, the other is notThe reason is plain; in the one case it is spent to enable the concern to yield profits in the future, in the other it is spent in working the concern for the present production of profit.’

In *New State Areas v CIR (supra)* at page 627, Watermeyer CJ said:

*“... 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...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 a revenue expenditure...”*
(emphasis added)

It may, therefore, be concluded from the above that where the expenditure is more closely related to the establishment, improvement or maintenance of the taxpayer’s

income-producing structure than to the working of its income-earning operations, it is capital expenditure.

In determining whether the expenditure is closely connected to the income-producing operations, regard is to be had of the purpose of the expense, and the effect thereof. In each instance, regard must be had to the entire surrounding circumstances attendant upon each particular set of facts. The decision should be based on what the overall enquiry reveals.⁵⁶

The test relating to income-producing structure versus working of income-earning operations is supplemented by the so-called “subsidiary tests” laid out by our courts namely:

- whether the expense creates an **enduring benefit**;
- whether the expense relates to the taxpayer's **fixed or floating capital**; and
- whether the expense settles a matter **once and for all**.

None of these tests is conclusive. Set out below is a summary of these tests.

Enduring benefit

In terms of the enduring benefit test, the question is whether the taxpayer obtained an enduring benefit by incurring the expenditure or as a result of the expenditure. If so, the expense is capital in nature.

In *ITC 1528*⁵⁷, at pages 248 and 249, the court held that:

*“The test that an expenditure will be regarded as an expenditure of a capital nature if it achieves a **benefit or advantage** of an enduring nature was adopted and applied by Steyn CJ in considering the peculiar facts in Commissioner for Inland Revenue v African Oxygen Ltd 1963(1) SA 681(A) at 689 ... It will be seen from the foregoing decisions that in as much as the expenditure brought the taxpayer no asset of any*

⁵⁶ *Natal Estates Ltd v Secretary for Inland Revenue* (1975) 37 SATC 193

⁵⁷ *Income Tax Case No. 1528* (1991) 54 SATC 243(T)

*nature, nor did it enhance or preserve an asset it was found that there was no **advantage or enduring benefit** of the trade and that the expenditure was therefore not of a capital but of a revenue nature.” (emphasis added)*

In *Palabora Mining Co Ltd v SIR*⁵⁸, the taxpayer incurred expenditure on another person’s land to build a dam. The purpose of the expenditure was not to obtain a long-term water supply, but to accelerate the acquisition of water supply, which was needed by the taxpayer to commence with its mining activities sooner. The court held that, as a governmental institution would have supplied the water in any event, no enduring benefit was obtained; therefore the expense was not of a capital nature.

In the case of *Heron Investments (Pty) Ltd v Secretary for Inland Revenue*⁵⁹, dealing with expenditure incurred by a property-owning company to secure the extended tenancy of a desirable tenant, the court held on page 182 with reference to whether an enduring benefit was obtained by the taxpayer, that the expenditure:

“...constituted expenditure incurred in order to equip its income earning structure and so enable it to obtain the advantage of a long tenancy of a desirable tenant; as such the advantage sought and obtained by the appellant was one for the enduring benefit of its trade and the expenditure incurred in obtaining it was of a capital nature...”

According to Silke⁶⁰ (De Koker A.P. and Williams R.C. 2011), the ‘enduring benefit’ test has been repeatedly affirmed and received an important qualification in English law,⁶¹ where it was held that by ‘enduring’ is meant ‘enduring in the way that fixed capital endures’. In Silke’s view (De Koker A.P. and Williams R.C. 2011); this introduced into the test the distinction between the ‘fixed’ capital and the ‘floating’ capital of a trade.

⁵⁸ *Palabora Mining Co Ltd v Secretary for Inland Revenue* (1973) 35 SATC 159

⁵⁹ *Heron Investments (Pty) Ltd v Secretary for Inland Revenue* (1971) 33 SATC 181

⁶⁰ At chapter 7.9

⁶¹ *Anglo-Persian Oil Co Ltd v Dale*, as quoted by Silke at chapter 7.9

Fixed versus floating capital

In the *New State Areas Ltd* case (*supra*), at page 164, Watermeyer CJ held that:

“When the capital employed in a business is frequently changing its form from money to goods and vice versa (e.g. the purchase and sale of stock by a merchant or the purchase of raw material by a manufacturer for the purpose of conversion to a manufactured article) and this is done for the purpose of making a profit, then the capital so employed is floating capital.”

Accordingly, the acquisition cost of fixed assets is non-deductible and generally speaking, expenditure incurred in relation to floating capital employed in a business for the purpose of making a profit would be of a revenue nature.

Once and for all

In coming to its decision the court, in the *New State Areas Ltd* case (*supra*), considered the test laid down by the English court in *Vallambrosa Rubber Company v Farmer*⁶², where the court held that expenditure incurred once and for all is capital expenditure and recurrent expenditure is revenue expenditure.

It is submitted, however, that this test could, at best, merely serve as an indicative factor in determining the nature of an expense, as the mere fact that an amount is paid as a lump sum, does not *per se* mean that that expense is of a capital nature (and *vice versa*). It is, therefore, submitted that the preceding tests or criteria should not be invalidated by a “once and for all” approach.

Summary

The pre-eminent and principle test in determining whether expenditure is of a capital or revenue nature is to make an inquiry as to whether the expenditure forms part of the cost of performing the income-earning operations or part of the cost of establishing, enhancing or adding to the income-earning structure.

⁶² *Vallambrosa Rubber Company v Farmer* 5 Tax Cases 529

Should the above test not suffice, the ‘enduring benefit’, ‘fixed *versus* floating capital’ and ‘once and for all’ subsidiary tests may be looked to for further guidance. However, in all instances the facts and circumstances of each case must be considered.

3.3 Specific case law in relation to contingent liabilities and the sale of a going concern

With the above analyses of the general deduction formula, the rest of this chapter will focus on specific court decisions in respect of the tax deductibility of accounting provisions and contingent liabilities when it is transferred in the sale of a business as a going concern.

3.3.1 ITC11107

In an unreported South African case *ITC 11107*⁶³ the taxpayer concluded a written agreement with B to purchase part of B’s business. In terms of the sale agreement, the taxpayer was substituted in the place of B in respect of contracts of employment in existence at the time of the sale of the business and all rights and obligations were transferred to the purchaser (as required by section 197 of the Labour Relations Act No. 66 of 1995). The taxpayer was consequently obliged to make payment of a “13th cheque” (per the employment contract) to such employees transferred. The taxpayer claimed a deduction for the amount paid in respect of the 13th cheque payments, as an expense incurred in the production of income, which is not of a capital nature. Discretionary bonus payments were also made to senior managers, and the taxpayer, similarly, claimed a deduction for such amounts paid. The Commissioner disallowed the deduction of both the 13th cheque payments as well as the discretionary bonuses paid to senior managers on the basis that such expenses formed part of the purchase price of the business and were, therefore, of a “capital nature” as envisaged in section 11(a) of the Act and hence not deductible.

⁶³ *Case No. 11107 (2005)*

The court held that the provisions taken over were in fact deductible in the hands of the purchaser on the actual discharge thereof.

In this case, the assumption of the provisions formed part of the purchase price of the business. It is submitted that an important factor in the court's decision was the fact that the assumption of the provisions were appropriately worded in the sale agreement i.e. all rights and *obligations* in respect of the employment contracts of the seller were transferred to the purchaser. Therefore, when the time came to pay bonuses to the employees, the purchaser had an unconditional liability to make payment, and therefore it had expenditure actually incurred in the production of its income as the new employer.

It is however respectfully submitted that, the Commissioner's submissions in respect of the potential "capital nature" of the expenses, due to its link to the purchase price of the business, may have been inadvertently overlooked by the court.

3.3.2 New Zealand case

In an earlier New Zealand case,⁶⁴ the facts were as follows:

In terms of the sale agreement, the purchaser of a business assumed the seller's liabilities to its employees, such as their entitlement to paid leave. Such liabilities were taken into account in calculating the cash consideration paid by the purchaser for the business. The purchaser claimed a deduction for the amounts paid to settle such obligations, subsequent to the acquisition of the business. The court was asked to decide whether later payments satisfying those liabilities were deductible expenses.

The Court *a quo* held that the expenditure was deductible but after an appeal from the revenue authorities (i.e. from the New Zealand Court of Appeal) to the Privy Council, the original judgment was overruled and the deduction of the later payments was disallowed.

⁶⁴ *Commissioner of Inland Revenue v New Zealand Forest Research Institute Ltd* (2000) STC 522

The Privy Council held that the payment was part of the capital consideration paid for the business and was hence of a “capital nature” and, therefore, not deductible in the hands of the purchaser.

3.3.3 Ackermans case

In the recently decided *Ackermans* case (*supra*), which was first heard in the South Gauteng Tax Court during 2009 and reported as *ITC 1839 (supra)*, the facts were as follows:

- The purchaser paid a net purchase price of R800 million for the acquisition of a business which comprised the net of assets of R1 129 million less total liabilities of R329 million.
- Included in the total liabilities were three contingent liabilities which amounted to approximately R17 million.
- The purchase price was not allocated across the assets and liabilities, the sale agreement did not specify that the seller was obliged to make payment to the purchaser in respect of the transferred contingent liabilities and no payment was actually made (hereinafter referred to as “physically” paid) by the seller to the purchaser for the assumption by the purchaser of the liabilities.
- The three contingent liabilities were:
 - R9.8 million in respect of Ackermans’ contractual obligation to fund post-retirement medical aid benefits;
 - R6.3 million in respect of Ackermans’ obligations to employees under a long-term bonus scheme; and
 - R900 000 in respect of repair obligations undertaken by Ackermans’ under property leases.
- The seller claimed a deduction in terms of section 11(a) of the Act on the basis that it had “actually incurred” expenditure, in terms of the sale agreement, in an

amount equal to the value of the contingent liabilities, by foregoing a portion of the asset purchase price.

South Gauteng Tax Court judgment

Unlike the SCA (see below), the lower court, based on the facts of this particular case, considered all the elements of the general deduction formula and, as a result, held as follows:

- in the transactions in issue there had been no diminution of the seller's patrimony and it had suffered no loss as the seller had been relieved of the risk that the contingent liabilities in issue would materialise;
- the contingent liabilities, until they became unconditional, did not constitute 'incurred' expenditure and as there was no obligation on the seller to effect payment no expenditure relating thereto could possibly have been incurred;
- the 'notional agreement expenditure' had not been incurred in the production of income prior to the sale of the business;
- expenditure incurred in relation to the sale of the business was more closely connected to its income earning structure and was, therefore, of a capital nature;
- such expenditure was not laid out or expended for the purposes of the seller's trade; and
- accordingly, the deduction in respect of the contingent liabilities assumed by the purchaser on the sale of the business was not allowable (to the seller) in terms of the Act.

Supreme Court of Appeal judgment

As opposed to the lower court, the SCA only found it necessary to consider one of the elements of the general deduction formula, namely, whether there was "expenditure" or "expenditure actually incurred" by the seller in respect of the contingent liabilities. The court looked specifically at the wording of the agreement, which appears from the facts to have reflected only a lump sum purchase price paid by the purchaser for the

business as a going concern. Counsel for the appellant (the seller) argued that the court, in reaching its decision, should not limit itself to the wording of the agreement, but that the economic consequences of the transaction should be taken into account.

The court dismissed the appellant's argument and held that:

- no liability was incurred by the seller to the purchaser in terms of the sale agreement;
- the manner in which the purchase price was discharged by the purchaser did not result in the discharge of any obligation owed by the seller to the purchaser;
- the seller owed the purchaser nothing in terms of the sale agreement; and
- therefore, no expenditure was incurred by the seller.

The court noted that "one looks in vain for a clause in that agreement" that has the effect of creating an obligation on the seller towards the purchaser in respect of the transferred contingent liabilities. It may, therefore, be inferred (as alluded to by the court)⁶⁵, that should the two parties have been mutually indebted to each other and both debts were liquidated and fully due, the seller may have been able to successfully place reliance on set-off. However, in the courts view, that is not what happened in this case and the argument based on set-off was correctly abandoned by the seller.

The SCA, consequently, did not consider whether the remaining requirements of the general deduction formula would be met by the seller in respect of the expenditure.

The SCA has, however, pronounced in an *obiter dictum* that there would be no restriction to the purchaser deducting the contingent liabilities in due course, as and when they became unconditional. This was apparently the view also of the representative for the SARS but no analysis of the reasons for this finding was conducted (Kleynhans and Keirby-Smith 2011).

⁶⁵ At paragraph 8.

Summary

The only case noted above which constitutes binding authority in the South African legal context, based on the applicable facts of that case, is that of the SCA in relation to the *Ackermans* case (*supra*). The lower court judgment, however, provides useful guidance in determining the deductibility of contingent liabilities in the sale of a business as a going concern from the seller's perspective, with reference to all the elements of the general deduction formula.

Case No. 11107 (supra) is an unreported case heard by the South African Income Tax Special Court (which essentially has the status of a lower court) and the decision could be reversed on a subsequent appeal.

The New Zealand case is, similarly, not binding on South African courts. However, as the New Zealand case was decided in what appears to be the highest forum at that stage in New Zealand, its findings could be taken into account in South African courts, as it is by no means uncommon for a South African court to refer to international precedent (Ger 2009).

Despite the above cases, and as noted earlier in this study, a question which remained unanswered in both the lower and Supreme Court in relation to the *Ackermans* case (*supra*),⁶⁶ is whether the purchaser may claim the deduction in respect of contingent liabilities assumed, as the seller has been left without this benefit.

It is submitted, however, that the approach of the New Zealand case i.e. that the provision upon realisation is typically not deductible in the hands of the purchaser, especially if the assumption of such provision has been agreed between the parties as being part payment for the purchase price of specific business assets representing the consideration for those assets, is a favoured and principled view. This, however, leaves an undesirable situation where neither the seller nor purchaser may claim a

⁶⁶ Apart from the obiter dictum pronounced in the SCA.

deduction in respect of these contingencies. This scenario has, without a doubt, given new meaning to the phrase:

“there is no equity about a tax.”⁶⁷

Some commentators are of the view that while inequity is one thing, uncertainty is quite another (Ger 2009).

3.4 Conclusion

The above judicial decisions, therefore, supports the submission that there is a need for clear legislative intervention or guidance. This submission is further supported by the varying views, some of which are addressed in the following chapter, in respect of the tax deductibility of contingent liabilities when a business is sold as a going concern.

⁶⁷ Rowlatt J’s often quoted *dictum*.

4 Who may claim the deduction: the seller, purchaser or neither?

4.1 Introduction

With the above accounting, tax legislation and case law analysis as a backdrop, this chapter is focussed on the main research question i.e. who may claim a tax deduction in respect of transferred contingent liabilities (in general), when a business is sold as a going concern: the seller, purchaser or neither.

It is important, to at this stage, make a distinction between the transferred contingent liabilities for tax and accounting purposes. For tax purposes, the transferred contingent liabilities, comprise only the actual accounting provisions (as defined and discussed in Chapter 2) which have been recognised in the AFS of the seller at the date of the sale of the business, and therefore excludes accounting contingent liabilities (as defined and discussed in Chapter 2), as these are not recognised in the accounting records of the seller as such, apart from being required to be disclosed in the AFS.

The assumption of accounting provisions and liabilities as part of a sale of a business as a going concern, would by and large impact the cash (or otherwise) portion of the purchase price (i.e. the cash consideration payable by the purchaser). The cash consideration in relation to the assets is generally determined as the net asset value of the business (i.e. as the difference between the assets and the liabilities of the business). In other words, the purchaser acquires certain assets for cash and certain other assets in return for the assumption of the liabilities.

For example, the assets (fixed assets, trading stock and trade receivables) of a business are valued at R2 000, trade payables amount to R200, provision for bonuses, leave pay and other accounting provisions amounts to R300.

Generally, the parties have 3 options in respect of how the sale transaction could be structured with particular reference to the accounting provisions:

- 1) The seller could agree to physically pay the purchaser an amount for the assumption of the accounting provisions, and the purchaser could in turn agree to physically pay the seller an amount in respect of the assets of the business.
- 2) The purchase consideration of the business could be determined based on the net asset value of the business (i.e. assets less liabilities). In this instance the, agreement could state that the purchaser will acquire the assets of the business for a specified amount and assume the accounting provisions and other liabilities for another amount which is due by the seller (thus creating a legal obligation on the seller to settle the amount) and by set-off the net purchase price is paid.⁶⁸
- 3) The seller could simply retain the obligations in respect of the accounting provisions and liabilities and only sell the assets to the purchaser. (Kroukamp 2006)

Option 1 above, would clearly result in the seller having an amount (i.e. R500) being due and payable to the purchaser in respect of the assumption of the seller's accounting provisions and liabilities as at the date of sale of the business. The purchaser, on the other hand, would be indebted to the seller with respect to the assets of the business (i.e. R2 000).

If, for purposes of the above example, the business will be transferred as a going concern at net asset value (option 2 above), the purchaser will be required to pay the seller a cash amount of R1 500 representing assets to the value of R2 000 less the value of the liabilities R500. Consequently, the purchaser will be required to assume the liabilities as part of the acquisition of the business as a going concern. Thus, the purchaser will effectively be acquiring assets with a value of R2 000 and will be settling the purchase price in cash as well as with the assumption of liabilities (contingent or otherwise as in the *Ackermans* case (*supra*)). It is, therefore, apparent that the purchaser will be assuming the accounting provisions and liabilities as part of

⁶⁸ Based on the arguments of the appellant, this was the intended option in the *Ackermans* case (*supra*).

the consideration for the assets acquired. Accordingly, it could be argued that the seller will be realising its accounting provisions and liabilities by disposing of its assets under a sale of business, i.e. the seller receives R1 500 cash for its business but transfers assets of R2 000 and liabilities of R500 to the purchaser (alternatively the seller transfers R500 in assets (instead of cash) to the purchaser in order for the purchaser to take over its liabilities).

The difference between option 1 and 2 above is essentially that, the agreement of sale would create an obligation on both the seller and the purchaser to pay a specified amount to the other party (in the case of option 1); whereas the purchaser would be the only party obligated to make an actual payment to the seller (in the case of option 2) in exchange for the acquisition and assumption of the business' assets and liabilities respectively.

Option 3 would, inevitably, result in the seller being left with the obligation to settle the accounting provisions subsequent to the sale of the business. This in itself would not be a desirable position, if the seller ceases trading after the sale of the business (which may be the case in most instances), as the seller would be required to carry on a trade, *inter alia*, in order to be in a position to claim a deduction in respect of expenditure incurred in relation to the accounting provisions retained, subsequent to the sale of the business. However, the courts have held that expenditure incurred, after trading ceases, is still deductible in terms of section 11(a) of the Act, if the expenditure is incurred due to an obligation assumed while trading.⁶⁹

As this study aims to answer the question as to who may claim the tax deductions when accounting provisions or contingent liabilities are transferred in the sale of a business as a going concern, option 3 will not be further explored, as no transfer of accounting provisions or contingent liabilities occurs.

⁶⁹ *Income Tax Case No. 729 (1951) 18 SATC 96 at pages 100 - 101*

However, options 1 and 2 will be addressed, simultaneously, when critically analysing the tax deductibility of the contingent liabilities from the perspective of the seller and the purchaser.

As discussed in the preceding chapter, in order for expenditure incurred to be deductible, such amounts must meet the requirements of the general deduction formula i.e. the expenditure or losses must be actually incurred; in the production of income; laid out for the purposes of trade; and must not be of a capital nature.

Based on the above, and with the relevant judicial precedents highlighted in Chapter 3 as a guideline, in addressing the main research question of this study, differing views, in favour of and against, the tax deductibility of transferred contingent liabilities in the hands of both the seller and the purchaser are critically analysed below, with specific reference to the decisions in the Tax Court and SCA in relation to the *Ackermans* case (*supra*).

(The above scenarios are not the only ways in which a sale of business agreement can be structured. They are, however, commonly used arrangements in these circumstances and are, therefore, used as a basis for this study.)

4.2 Position of the seller

From the seller's perspective, the primary question is whether the seller has an unconditional obligation to pay the purchaser to assume its contingent liabilities; thus resulting in actually incurred expenditure when it pays the purchaser (in cash or otherwise).

Once the above has been established, the remaining requirements of the general deduction formula must be assessed, with each requirement imposing its own restrictions.

4.2.1 Views in favour of the seller

Expenditure actually incurred

As discussed in paragraphs 3.2.1, expenditure is not restricted to an outlay of cash, but includes amounts in a form other than cash.

In the situation where the seller physically pays the purchaser cash to assume the accounting provisions or contingent liabilities, the seller would have incurred expenditure in the form of a cash outlay. However, the fact that the seller transfers assets, as opposed to cash, should not detract from the fact that this form of settlement would still be considered to be “expenditure”.

The key distinction that should be made is that the question of whether there was expenditure “actually incurred” when the seller transfers contingent liabilities to the purchaser, should not refer to the actual incurrence in respect of the relevant contingent liabilities themselves, as these could only be said to be incurred when they become unconditional. The focus should therefore be on whether the seller actually incurred expenditure when it transferred the contingent liabilities to the purchaser as part of the sale of the business.

It may be argued that the undertaking to transfer assets (instead of cash) to the purchaser constitutes an actual incurrence or an unconditional liability to pay.

Alternatively, as in the *Ackermans* case (*supra*), the seller could, in effect, pay the purchaser to assume the contingent liabilities by way of set-off. While the sale agreement in the *Ackermans* case (*supra*) was not explicit as regards to set-off, the net effect of the manner in which payment of the purchase price was provided for suggests that this was the effect that the taxpayer sought to achieve, as the purchaser would not have agreed to take over the contingent liabilities without receiving consideration (cash or otherwise) from the seller for doing so (Kruger 2011).

It is therefore submitted that, if the sale agreement creates an obligation on the seller to pay an amount (in cash or otherwise) to the purchaser in return for the purchaser assuming the contingent liabilities, the seller would have actually incurred expenditure.

In the production of income

It is trite that, had the seller not sold its business, the expenditure incurred to settle the contingent liabilities, when the contingencies lift, would be incurred in the production of income of the seller⁷⁰.

Expenditure incurred after the business operations have ceased can also be regarded as being incurred in the production of income. In Kruger's (2011) view, on the assumption that the delegation of the liabilities had been validly executed, in law the seller had in fact discharged its previously contingent liabilities, which were clearly so closely linked to the seller's income-earning operations prior to its disposal so as to be regarded as part of the cost of performing such operations⁷¹.

The courts have considered the question of whether expenditure incurred after cessation of a particular trade can be claimed as a deduction against income from another trade carried on by the taxpayer, on a number of occasions. Whilst the case law on the matter is not harmonious, Meyerowitz (2008) submits that the correct decision is set out in *ITC 729 (supra)* where the court held that where an obligation was incurred prior to the cessation of the trade and for the purpose of earning income there is no reason, in principle, why such expenditure cannot be regarded as incurred in the production of income.

Laid out for the purposes of trade

Generally, accounting provisions such as provisions for leave pay, repairs, warranties etc. relates to the seller's trade, as these type of expenditure is to be expected when

⁷⁰ *Ackermans case (supra)* at paragraph 4

⁷¹ *Port Elizabeth Tramway Company (Pty) Ltd v CIR (supra)*

conducting a trade. The fact that these accounting provisions or contingent liabilities are realised (i.e. becomes an actual incurral by virtue of the obligation on the seller to pay the purchaser for the assumption thereof) through the sale of business agreement, does not preclude the expense from meeting the trade requirement. This is supported by the view that the underlying expenditure relating to the contingent liabilities were incurred by the seller while it was clearly still conducting its trade. Thus, such expenditure may be argued to be laid out or expended for the purposes of trade (Kruger 2011).

Not of a capital nature

Again, with reference to the underlying contingent liabilities being transferred to the purchaser, an argument could be raised that the seller is paying the purchaser to take over a liability which forms part of the income-producing operations, as opposed to a cost attached to the income-earning structure of the business. If the underlying contingent liabilities arise on a continuous basis as part of the cost of performing the business operations, and would as such be revenue in nature had the seller not sold its business, the expenditure incurred by the seller in respect of the contingent liabilities assumed by the purchaser would be revenue in nature (Kruger 2011).

In addition, as was submitted by the appellant in *ITC 1839 (supra)*, expenditure incurred by a taxpayer to rid itself of an anticipated or contingent revenue expense is generally itself of a revenue nature.⁷²

4.2.2 Views against the seller

Expenditure actually incurred

In the situation where the seller does not physically pay an amount to the purchaser or the agreement of sale does not infer an obligation on the seller to make such a payment, some may argue, as was the court's view in *ITC 1839 (supra)* that the payment by the seller to the purchaser to be relieved of its contingent liabilities is in

⁷² At page 62

fact a payment of the underlying conditional liabilities in respect of which there is no obligation to effect payment. Therefore, “no expenditure relating thereto could possibly have been incurred.”⁷³

Further, in this regard, in the *Ackermans* case (*supra*) the SCA was of the view that the seller had not incurred any expenditure under the sale agreement by saying that:

*“... ‘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 (i.e. the purchaser) 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. It is for this very reason that appellant in its oral submissions abandons any reliance on set-off, which would have been the inevitable effect if there had been reciprocal obligations.”*⁷⁴

As noted in the arguments in favour of the seller (above), what the court seems to suggest is that, had the seller been entitled to the full purchase price and explicitly agreed to pay an amount equal to the value of the contingent liabilities to the purchaser, set-off would have applied as there would have been the requisite reciprocal obligations between the parties (Kruger 2011). Consequently, there would be an actual incurral of an expense.

Therefore, where there is no express obligation on the seller to pay an amount to the purchaser in respect of the transferred contingent liabilities or where no payment was actually made by the seller, expenditure cannot be said to be actually incurred.

⁷³ At page 72

⁷⁴ At paragraph 8

In the production of income

The question one has to ask in order to determine whether expenditure was incurred in the production of income is what the purpose was of incurring the expenditure.

In *ITC 1839 (supra)*, the seller argued that the income to which the expenditure in question related was not the income arising on disposal of the business, but the income previously earned by the seller during the period that it traded prior to selling the business and had, accordingly, converted the underlying contingent expenditure into un-contingent expenditure.⁷⁵ Some may disagree with this argument and hold the view that the purpose of the payment (if there was one) was to induce the purchaser to assume the liabilities rather than being in the production of income prior to the sale of the business.⁷⁶

A further view is that the expenditure incurred by the seller would not be incurred in the production of income, as the purpose of the expenditure is not to produce income, but to bring to an end the trading activities of the seller (Olivier 2007).

Laid out for the purposes of trade

By virtue of the fact that the expenditure in question (i.e. payment by the seller to the purchaser in respect of the transfer/assumption, respectively, of contingent liabilities) was incurred with a view to enable the seller to sell its business as a going concern, and in particular, for the purposes of bringing to an end the seller's trading activities, it may be argued that, the expenditure was not laid out or expended for the purposes of the seller's trade.⁷⁷

Not of a capital nature

As in the case of the "laid out for the purposes of trade" argument, the views expressed by the Tax Court in *ITC 1839 (supra)* in respect of the capital or revenue

⁷⁵ At page 72

⁷⁶ As was the view of the Tax Court.

⁷⁷ *ITC 1839 (supra)* at page 73

nature of the expenditure in question is that as the “sale of the business would, by its very nature, cause a cessation of trading”. There would, therefore, be difficulty in successfully arguing that the expenditure incurred in relation to the sale would be more closely connected to the income-earning *operations* of the seller,⁷⁸ and thus be of a revenue nature; as opposed to being more closely linked to the income-earning *structure* of the business and thus be of a capital nature.

4.2.3 Recoupment in the hands of the seller

Section 8(4)(a) provides that when a deduction has been granted under certain sections of the Act and the deducted expenditure is recovered or recouped, then an amount is to be included in income as a recoupment (Rossouw 2010).

Therefore, where the seller pays the purchaser for the assumption of liabilities in respect of which a tax deduction was previously claimed by the seller, a recoupment in terms of section 8(4)(m) may arise, as the seller may be said to be relieved from the obligation to make payment of the underlying expenditure. However, where no deduction was claimed in respect of the underlying expenditure, due to the fact that the liability is contingent on the happening of an uncertain future event, it is submitted that, no recoupment would arise in the hands of the seller.

In the view of Rossouw (2010), if the seller is obligated to pay or actually pays an amount to the purchaser in order for the purchaser to settle the contingent liabilities at a future date when the uncertain events materialise, the seller would not be relieved of an obligation to make payment of the underlying expenditure but would actually make a payment, *albeit* to the purchaser for assuming the contingent liabilities. Thus, as submitted above, recoupment should not arise in the event of a seller transferring a contingent liability (i.e. a liability in respect of which it did not claim any tax deductions) to a purchaser.

⁷⁸ At page 72

4.3 Position of the purchaser

From the purchaser's perspective, the primary challenges are to determine whether the payments made by the purchaser when it settles the assumed contingent liabilities would be:

- in the production of the purchaser's income; or
- of a capital or revenue nature.

It is submitted, that much of the views in respect of the purchaser's position hinges on the question of whether the seller is obligated to pay or actually pays an amount to the purchaser for the assumption of the contingent liabilities or not.

4.3.1 Views in favour of the purchaser

Expenditure actually incurred

There is no doubt that the purchaser would, when settling the assumed liabilities in due course, have expenditure actually incurred, as an amount would be actually paid to the creditors in this regard.

In the production of income

In the view of Olivier (2007), the purchaser should be entitled to deduct expenditure, as being incurred in the production of income (and laid out for the purposes of trade – see below) once it is actually incurred, provided that it is expenditure of a revenue nature and on the basis that the purchaser does not accept a specific amount as payment for the assumption of the contingent liabilities, but rather accepts a reduced purchase price. The acceptance of a specific amount for the assumption of the contingent liabilities may be viewed as part of the cost of acquiring the business (which would be of a capital nature, and therefore not deductible) (In this regard, see the “not of a capital nature” discussion below).

Laid out for the purposes of trade

It is submitted that the same views expressed in respect of the question as to whether the expenditure was incurred in the production of the purchaser's income (see above), applies in this instance.

Not of a capital nature

The question to be considered in this context is whether the payments made by the purchaser, when it in due course settles the contingent liabilities by making payment to the creditors, would form part of the cost of the income earning-operations or the cost of establishing the income-earning structure.

As stated above, where the seller pays the purchaser a specific amount for the assumption of the contingent liabilities, and the purchaser expends amounts in respect thereof, the purchaser's expenditure could be viewed to form part of the cost of establishing (acquiring) the income-earning structure of the business, and therefore be held to be of a capital nature.⁷⁹

However, where the seller does not pay a specified amount to the purchaser, the expenditure incurred by the purchaser in settling the contingent liabilities may be held to be of a revenue nature if it forms part of the cost of the income-earning operations of the business (Olivier 2007).

4.3.2 Views against the purchaser

Expenditure actually incurred

There is again, no doubt that the purchaser would have actually incurred expenditure when it settles assumed contingent liabilities at a future date.

⁷⁹ Commissioner for Inland Revenue v New Zealand Forest Research Institute Ltd (*supra*) and New State Areas (*supra*)

In the production of income

As the expenditure incurred by the purchaser, when it settles the assumed contingent liabilities as a future date, would relate to the assumption of contingent liabilities of the seller, the purchaser would not have earned any income in respect of thereof, as the income was earned by the seller in prior years. The purchaser would, therefore, not have incurred the expenditure in the production of its income.

Laid out for the purposes of trade

As the purchaser would be carrying on a trade after the acquisition of the going concern, the expenditure subsequently incurred in respect of the contingent liabilities would meet the requirement of being laid out for the purposes of trade.

Not of a capital nature

As discussed in chapter 3, there are arguments, case law⁸⁰ and an *obiter dictum*⁸¹ which favour the view that a tax deduction may be claimed in the hands of the purchaser.

On the other hand, in the context of a sale of business as a going concern, where assets are bought and paid for through the assumption of an existing conditional obligation, the payment of that obligation (when the conditions lift) could be argued to be an expense of a capital nature, as supported by the Privy Council in *New Zealand Forest Research Institute (supra)*. This is due to the fact that a sustainable argument could be made that the only reason for assuming that obligation is to acquire the assets and not to fund a mere operating expense. As such, the amount laid out in respect of the contingent liabilities so assumed (when paid out by the purchaser to the relevant parties) could represent expenditure of a capital nature, which would not be deductible for income tax purposes.

⁸⁰ Unreported Case No. 11107 (*supra*)

⁸¹ *Ackermans case (supra)*

4.3.3 Is there merit in the *obiter dictum* pronounced in the *Ackermans* case?

An *obiter dictum* is better known as a statement “said in passing” or a remark or observation made by a judge that, although included in the body of the court's opinion, does not form a necessary part of the court's decision. *Obiter dicta* are not the subject of the judicial decision, even if they happen to be correct statements of law. Statements constituting *obiter dicta* are not binding, although in some jurisdictions, such as England and Wales, they can be strongly persuasive.⁸²

Thus, although not necessary for the decision at hand in the *Ackermans* case (*supra*) i.e. whether the seller may claim deductions in respect of the contingent liabilities transferred to the purchaser, Cloete JA found it appropriate to state, in his closing remarks, that there would be no bar to the purchaser “deducting the liabilities as and when they became unconditional, as counsel representing the Commissioner rightly conceded”⁸³.

It is respectfully submitted that this *obiter dictum* is not correct in law, for the reasons discussed in relation to the purchaser's position above, despite the fact that it seems to accord with Olivier's view. It is submitted that, just as the seller was restricted from claiming the deduction in terms of the general deduction formula i.e. it was found that there was no expenditure actually incurred by the seller, the purchaser would be faced with similar challenges e.g. was its expenditure incurred in the production of income and not of a capital nature. Further, as no support was provided by the court in respect of this *dictum* or SARS in its concession thereto, it is difficult to see on what basis this statement could be persuasive.

However, to the uninformed taxpayer (purchaser), this may be the only support it has in respect of its claims for deductions in respect of assumed contingent liabilities. As respectfully submitted above, since this dictum is not founded on principles prevailing

⁸² Black's Law Dictionary page 967 (5th edition 1979) as quoted on Wikipedia at http://en.wikipedia.org/wiki/Obiter_dictum

⁸³ At paragraph 9

in the current tax legislation (or legislation as it stood at the time of the court's judgment), there would be no reason why the Commissioner would not deny the purchaser such a deduction.

4.3.4 Treatment of amount received by the purchaser in respect of contingent liabilities assumed

In the case where an amount is paid to the purchaser by the seller to take over the contingent liabilities, the amount received by the purchaser may be taxable in its hands if considered to be a receipt of a revenue nature (a section 24C deduction may be claimed in this regard). Section 24C effectively provides that an allowance may be claimed against the amount included in taxable income to the extent of the future costs which the taxpayer may need to incur to deliver goods/services related to the amount received and taxed. A deduction may then also be claimed under section 11(a) when the settlements are made by the purchaser (barring the "not of a capital nature" requirement, as discussed above, is met. Effectively, the purchaser is taxed on the part of the amount received which has not been used to settle the liability (Olivier 2007). However, the receipt could be argued to be capital in nature, because of its close association with the acquisition of a capital asset (i.e. the business), and therefore in this case, settlement by the purchaser at a future date could also be argued to be capital in nature (Rossouw 2010).

4.4 Conclusion

From the above analysis, it is evident that when a business is sold as a going concern, the question of the deductibility of contingent liabilities transferred in the sale of the going concern, can be a "tax minefield" (Olivier 2007) for both the seller and the purchaser.

In light of the above, there are strong arguments that where contingent liabilities arise as a result of the conduct of the seller's ordinary income earning operations, that expenditure uncured in settling such liabilities would be sufficiently closely connected

with such operations, would be laid out or expended for the purposes of trade and would be part of the cost incidental to the performance of the income producing operations of the seller. Accordingly, the expense would be deductible in terms of the general deduction formula and an argument could be made that the realisation of the contingent liability by the seller should be deductible in the hands of the seller. In essence, in order for the seller to claim a deduction, it would have to pay or incur an absolute and unconditional liability to pay the purchaser for the assumption of the contingent liability as part of the sale of the business transaction (Olivier 2007).

From the purchaser's perspective, the biggest challenges are in respect of the "in the production of income" and "capital vs. revenue nature" arguments. As the expenditure incurred relates to income which has previously been earned by the seller, the purchaser would have difficulty in successfully arguing that the expenditure (when settled in subsequent years) has been incurred in the production of its income. Further, the purchaser can be argued to be acquiring a capital asset (i.e. the business, which includes various assets and liabilities (contingent or otherwise)), in respect of which any subsequent payments to settle the liabilities so acquired would be of a capital nature (due to its link to the initial business acquisition transaction). However, since there now is an *obiter dictum* on the matter (from the purchaser's perspective), there is (until proven otherwise) nothing stopping the purchaser from *attempting* to claim the deductions, although, as submitted, this approach is not currently supported by law.

Notwithstanding the above, however, it is especially important that the agreement of sale be properly structured, giving appropriate consideration to the tax consequences applicable to each party. As is evident from the above, like other terms of the agreement, what may be favourable for the purchaser, may not necessarily be favourable for the seller, and vice versa (Kroukamp 2006).

5 Prospective legislative intervention or guidance

5.1 Introduction

As noted in paragraph 1.1, although the proposed amendments in respect of the tax treatment of contingent liabilities, where a business is sold as a going concern, have been withdrawn, these proposals are worth noting briefly as we may see the same reflected in an interpretation note or binding class ruling issued by SARS in the near future.

5.2 Rationale and proposal

In terms of the Explanatory Memorandum to the 2011 DTLAB, the differing views and interpretations (some of which were discussed above) in relation to the deductibility of transferred provisions or contingent liabilities in the sale of a business as a going concern, is a clear indication that the current law is “somewhat uncertain”.

Based on these uncertainties, the 2011 DTLAB proposed to remove this uncertainty by clarifying who may claim deductions in respect of these contingent liabilities and how this should be accounted for in both the hands of the seller and the purchaser. Essentially, the proposal favoured the view that the seller would be entitled to a deduction with the purchaser being required to keep track of the contingent liabilities assumed and subsequently settled (as they become due during the ordinary course of its trade).

5.3 Position of the seller

From the seller’s perspective, it was proposed that the seller should add the fair market value of the contingent liabilities (as opposed to the face value of fixed liabilities assumed) to its gross receipts.⁸⁴

⁸⁴ Alternatively proceeds on sale. However, as the capital gains tax implications in respect of assumed contingent liabilities are excluded from the scope of this study, no further consideration of the proposed capital gains tax implications will be discussed.

As stated above, the seller would have been entitled to a deduction in respect of the transferred contingent liabilities on the basis that the reduced cash consideration on sale of the going concern would be viewed as a cost “actually incurred” in “carrying on any trade” in terms of the general deduction formula.

5.4 Position of the purchaser

The purchaser would have been required to add the same fair market value of the assumed contingent liabilities to the consideration paid in respect of the acquisition.

However, the purchaser would not be allowed to claim a deduction in respect of the same contingent liabilities (i.e. to avoid double deductions) and would have to:

- include the value of the assumed contingent liabilities in its gross income;
- simultaneously, claim an upfront allowance in respect of the same amount included in gross income;
- add back and roll-forward the allowance during post acquisition years; and
- reduce the allowance and add-backs as payments are made in settlement of the assumed contingent liabilities.

5.5 Potential limitations or shortcomings

Shortly after the publication of the 2011 DTLAB, the following comments, *inter alia*, were made in respect of the 2011 DTLAB, as it relates to the above (Durban Chamber of Commerce and Industry 2011):

- The wording of the proposed section, allowing the seller to claim the deduction, could have been interpreted so that even the partial assumption of a contingent liability justified the deduction of the market value of the full contingent liability.
- There should have been a linkage between the abovementioned section, the corresponding gross income definition and the purchaser’s allowance section to ensure that the market value of the contingent liability concerned is the same amount.

- Furthermore, market value should only apply if the parties have not agreed a value. Market value of a contingent liability is difficult to determine, may need to take into account the time value of money, and seller and purchaser might determine different values.
- The purchaser's allowance section did not achieve the stated objective of removing the uncertainty of the availability of the deduction to the purchaser. The requirement that the expenditure "would ...have been allowed as a deduction" implies that the deduction must be permitted by section 11. A contingent expenditure liability may, depending on the nature thereof, be incurred in the production of the seller's income, not the purchaser's income. It would seem that a deemed expenditure amendment is also necessary to cater for the position of the purchaser.

5.6 Conclusion

Following from the existing legislation and case law, as analysed in the foregoing chapters, and the above submission of shortcomings or limitations in respect of the proposed amendments to legislation, it is not clear why the proposed amendments have been withdrawn.

Considering the fact that the sale of a going concern is not uncommon practice in South Africa, it is submitted that the fact that there are so many differing views or interpretations on the eligibility of the seller or the purchaser in respect of the deductibility of transferred contingent liabilities, would indicate that authoritative legislative intervention is required sooner rather than later.

6 Conclusion and recommendation for future research

6.1 Conclusion

This dissertation examines who may claim the tax deduction in terms of transferred accounting provisions or contingent liabilities when a business is sold as a going concern: the seller, purchaser or neither.

In chapters 2 and 3 it was illustrated that the meaning of provisions and contingent liabilities are not the same for accounting or tax purposes. Similarly, the treatment of these items differs in normal trade circumstances or when transferred to a purchaser in the sale of a going concern.

For accounting purposes, a liability arises either from a legal or a constructive obligation, whereas for tax purposes a liability stems only from a legal obligation.

An accounting provision is a liability of uncertain timing or amount. An accounting contingent liability is a possible obligation with an uncertain outcome or a present obligation which is not probable or in respect of which the amount of the obligation cannot be reliably estimated.

For tax purposes, provisions or contingent liabilities are conditional liabilities i.e. conditional upon the happening of some future event.

When a business is sold as a going concern, for accounting purposes, the purchaser does not claim a deduction in respect of the assumed contingent liabilities. The seller, on the other hand, would have claimed the accounting deduction when it initially recognised the accounting provisions or contingent liabilities.

From a tax perspective, contingent liabilities are only deductible when a taxpayer incurs an unconditional obligation to settle the amount.

In chapter 4 it was shown that strong arguments exist in favour of the seller claiming the tax deduction. However, in light of the *Ackermans* case (*supra*) sellers may not be as bold in future. The purchaser, on the other hand, would be considered to be expending amounts in respect of a capital asset acquired (i.e. the business), when it eventually settles the contingent liabilities. However, the *obiter dictum* in the *Ackermans* case (*supra*) leaves the door open to the purchaser to decide if it will make a claim when the expenditure is actually incurred.

For the seller, it may be more beneficial to insert a clause in the sale agreement which has the effect of creating a liability on the seller to pay a specified amount to the purchaser for the assumption of the contingent liabilities. This would assist in demonstrating that the seller has actually incurred expenditure. However, the remaining requirements of the general deduction formula are not that easy to satisfy, especially in the situation when the seller ceases to trade.

From the purchaser's perspective, a payment from the seller for the assumption of the contingent liabilities could be detrimental in its endeavours to claim the tax deductions, as the amounts expended could be held to be of a capital nature. In addition, even if the purchaser does not receive payment from the seller, the *onus* would be on the purchaser to prove that the expenditure it incurs, when settling the liabilities in future, was incurred in the production of its income.

From the above, it would appear as if either the seller or the purchaser could be successful in making a claim for the tax deductions, subject to appropriate wording in the sale agreement. However, where all the requirements of the general deduction formula are not met, in either case, neither the seller nor the purchaser would be able to claim the tax deduction.

It is, however, submitted that based on the law as it currently stands, neither the seller nor the purchaser should be allowed the deduction, for the reasons discussed in chapter 4.

Notwithstanding the above submission, if any party stands a chance at making the claim, it is further submitted that the seller would be in a better position to substantiate such a claim, subject to the sale agreement being appropriately worded to create an obligation on the seller to compensate the purchaser for the assumption of the contingent liabilities. This would, therefore, result in the seller having an unconditional obligation to settle the amount and, therefore, it will have actually incurred expenditure, which appears to be its primary hurdle with reference to the general deduction formula.

However, in light of the *obiter dictum* and the view expressed by SARS in the DTLAB, the former suggesting that the purchaser may be successful in making such a claim and the latter proposing that the seller be allowed the deduction, the preceding submission, may be overruled in practice.

With so many differing views on the matter, however, it is surprising that the proposed amendments discussed in chapter 5 have been withdrawn, but at the same time, it is also understandable for the same reason. It is, however, vitally important to be cognisant of the fact that the facts and circumstances of each case will differ depending on the wording of the sale agreements as there are currently no specific legislative guidance for taxpayers in this regard.

6.2 Recommendation for future research

It is submitted that, the much anticipated legislative intervention or guidance that has been promised by the Standing Committee on Finance, in the Draft Response Document from National Treasury and SARS in respect of the 2011 DTLAB, would most certainly be a document(s) to look forward to and analyse in the near future.

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