THE EFFECTS AND INFLUENCES OF SOUTH AFRICAN TAXATION ON THE VALUATION OF COMPANY SHARES, BUSINESS INTERESTS AND OTHER ASSETS

by

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Research dissertation presented for the approval of the Senate of the University of Cape Town in fulfilment of part of the requirements for the degree of Master of Laws in an approved course and a major dissertation. The other part of the requirements for this degree was the completion of a course programme.

OCTOBER 1991

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"Any fool can buy a company - but buying wisely and for value is the difference between success and failure."

W A M Clewlow of Barlow Rand

The ultimate test of an acquisition, if not the only reliable test, is whether or not it creates economic value for shareholders.

I dedicate this modest document to my wife, Michelle, and my three children, Hayley, Mandy and Joanne, in gratitude for their love, support and encouragement.

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ABBREVIATIONS

A	Appellate Division of the Supreme Court of South Africa
AC	Law Reports, Appeal Cases, House of Lords
AD	Reports of the Appellate Division of the Supreme Court of South Africa
AllER	All England Law Reports
ATR	Australian Tax Reports
C	Cape Provincial Division of the Supreme Court of South Africa
Ch	Chancery Division
CIR	Commissioner for Inland Revenue
COT	Commissioner of Taxes
CPE	Reports of the Cape Provincial Division of the Supreme Court of South Africa
E	Eastern Cape Division
IRC	Inland Revenue Commissioners
ITC	Income Tax Case (Special Court)
KB	King's Bench Division
KBI	Kommissaris van Binnelandse Inkomste
N	Natal Provincial Division of the Supreme Court of South Africa
NPD	Reports of the Natal Provincial Division of the Supreme Court of South Africa
NR	High Court, Northern Rhodesia
SA	South African Law Reports
SATC	South African Tax Cases
SBI	Sekretaris van Binnelandse Inkomste
SIR	Secretary for Inland Revenue
SR	High Court of Southern Rhodesia
TC	Reports of Tax Cases (United Kingdom)
TPD	Reports of the Transvaal Provincial Division of the Supreme Court of South Africa
T	Transvaal Provincial Division of the Supreme Court of South Africa
TS	Transvaal Supreme Court Reports
WLD	Reports of the Witwatersrand Local Division of the Supreme Court of South Africa
W	Witwatersrand Local Division of the Supreme Court of South Africa
WLR	Weekly Law Reports

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PREFACE AND ARRANGEMENT OF THIS DOCUMENT

This document has been prepared in two parts.

The first part deals with some basic aspects of valuations and the major aspects of taxation which should be borne in mind by a valuer.

The second part, which commences on page 102, is a compendium of brief comment on tax matters and tax cases which may be of interest to a valuer.

The document is based on research carried out in relation to:

- The Income Tax Act No. 58 of 1962, as amended, inclusive of the 1989 Amending Act;
- The Sales Tax Act No. 103 of 1978, as amended; and
- The Estate Duty Act No. 45 of 1955, as amended.

Due to subsequent amendments to the legislation certain aspects of taxation dealt with in this document may no longer apply, but there has been comment and expectations in many instances that some of the changes are likely to be reintroduced. I have accordingly included my findings from the research carried out as this could be helpful in the event of a reintroduction of the affected legislation.

Since preparing this document, The Sales Tax Act is no longer of force or effect and has been replaced with The Value Added Tax Act of 1991. There are many aspects of this new legislation which also require the consideration and attention of a valuer. I have not dealt with these aspects in detail in this document.

INTRODUCTION

On referring to court cases where valuations have for some reason or another been the subject of litigation, students and laymen may well be inclined to call into question the expertise of many of the experts undertaking the valuations. The English case of Holt vs. CIR (1953) 2 ALL ER 1501 comes to mind, in which the valuation of a shareholding in a private company arrived at by one expert was three times greater than that calculated by another expert.

Commenting on the case Holt vs. CIR, Mr T A Hamilton Baynes says, "The Harley Street specialist will give his opinion on an unusual prognosis and will not be unduly surprised if his colleague from Wimpole Street produces a different opinion." This does not make us lose faith in the medical profession but only serves to emphasise the problems with which it has to deal. An appraisal of the 'going concern' value of a complex economic institution is said to be as complicated an exercise as the probing of the dim world of the internal workings of the human body (Aspects of Accounting and Auditing at page 116).

For the benefit of the cynic, who is described by one of Oscar Wilde's characters as "a person who knows the price of everything and the value of nothing", it is appropriate to consider the term 'valuation' as defined in the Shorter Oxford Dictionary:

"An estimate based on probabilities"

Accordingly a valuation is nothing more than an opinion, hopefully based upon knowledge and experience rather than being an uninformed, unresearched guess.

A major area of knowledge required by the expert valuer in order to carry out his or her function in the most responsible manner is, in my opinion, taxation and its effects upon all aspects of a business, assets or liabilities, and the manner in which different forms of transactions may or may

not affect such taxation. Such knowledge, when applied together with all the other factors which should be considered by the expert when undertaking a valuation, will enable the expert to carry out his duty in the most efficient and professional manner. Without an intimate knowledge of taxation, it is my opinion that a valuer, in carrying out his duties as such, may well be incorrectly equipped to express an opinion which has considered every aspect that may be relevant to and influence such opinion.

Other than a basic introduction to valuations and some of the basic factors that should be considered by the valuer, the subject matter of this document will be confined to the taxation considerations and the effects and influences of taxation on the valuations of assets, liabilities, businesses, shares and anything which may be commercially valued.

Every valuation, irrespective of its purpose, must be carefully considered on its own merits and with its varying factors and degrees of complexity and emphasis. No standard formula can be applied in order to produce satisfactory results automatically.

> "Unless the valuer comes to each new task in an objective frame of mind - fully informed on the fundamental principles of valuation, but completely open-minded on the requirements of the particular problem before him - he is likely to produce an unsound valuation. Sooner or later - probably sooner - it will be exposed to attack, and it may not stand the ultimate test of 'a fair valuation as between a willing but not anxious seller, and an equally willing but not enthusiastic buyer'."

- Valuation of Shares in Private Companies by R E Tonkin
The Chartered Accountant in Australia, May 1958.

I will attempt in the pages that follow, to set out some of the aspects of valuations and various taxation aspects which should be investigated when undertaking a valuation irrespective of its ultimate

purpose. I will set out some of the case law in support of many of the aspects with which I will deal, and, I will also set the scene with some of the basic underlying taxation principles which it is necessary to understand in order to appreciate many of the principles applied by the courts in arriving at their decisions.

This document is based on the legislation in existence at March 1990 and prior to the promulgation of the 1990 Income Tax Act. However, in certain instances the effects of later legislative changes have been commented upon. Many of those changes have been controversial and from time to time there has been comment that there is likely to be a reintroduction of some of the legislative provisions which have been amended or eliminated. In particular I refer to the provisions relating to dividends and loans to members of close corporations and to shareholders of companies.

In the course of my research I have not found any acknowledged or regular publications which specifically deal with the subject of taxation and valuations.

DEFINITION OF "VALUATION"

1. "The act or process of valuing or of estimating value or worth: as (a): the act or process of setting or determining the price of something: appraisal (b): the determination of the present value of a life insurance policy as measured by the difference between the present value of the benefits promised and the present value of all the premiums expected to be received on the policy.

2. The value or price set upon something is its estimated or determined market value."

- Wester's Third New International Dictionary

Valuatiôns are the opinion of the preparer thereof and due to the multitude of matters that must be considered in carrying out a valuation and the separate assumptions and opinions applied in the process, it is seldom, other than in the case of fixed factors being applicable, that the valuations of two or more valuators are likely to coincide. Generally a valuation is the estimate of the approximate value of worth of the item being valued based on the assumptions and information used. Very often valuations are made without adequate consideration of the tax consequences that could arise due to past actions of the present owner, or the intended or future actions of the purchaser.

In order to obtain a fair market value it is not unusual for the role of the valuer to be occupied by a chartered accountant who is an independent professional appointed, carefully selected for his knowledge, experience and expertise of the rules, regulations, legislation, precedents and current conditions applicable to the nature of the valuation to be undertaken.

Valuations are very much subjective and dependent upon the exercise of the judgement of the individual, and in making a valuation judgement the valuer will have regard to the nature of the valuation assignment and will be influenced by financial, operating, marketing, legal, taxation and

other applicable considerations. Accordingly, the opinions of experts in any area relating to a valuation should be sought prior to any final overall conclusions being reached. The valuer's conclusions must ultimately be firmly based upon knowledge actually possessed by the valuer and not knowledge merely professed.

The valuer's opinion of value will not always be translated precisely into a final purchase or selling price. The parties may well be prepared to add or deduct factors of their own choice. D A Mallinson in the book "Share Valuations" stated:

> "This is not a cause for despair - even when all the required ingredients have been mixed in exactly the correct proportions, the buyer will pay that much more or the seller will accept that much less, not through perversity, but intuitively, or perhaps even from the same motivation as leads to the buying of a motor car because of the colour of the upholstery."

D A Mallinson also states:

> "... a businessman appraises the value of his merchandise in terms of his assessment of the market. It is important to note that every such assessment is a matter of individuality; one man expects, another hopes, a third despairs - in each the assessment reflects the appraiser's attitude."

PURPOSE OF A VALUATION

Valuations are of great importance in the investment decision-making process in the world of free enterprise. This process is an ongoing process whereby investors regularly wish to add to, dispose of or adjust their investment portfolios. In order to do so to best commercial advantage they require to know and understand the value of the asset, goods or service which they intend to purchase or sell.

Valuations are undertaken for a wide range of reasons on a daily basis. Some of these reasons are:

- The evaluation of the value of an investment opportunity for an investor into a business, shares or an asset.

- The evaluation of the value of an asset held in order to compare its value and the income, if any, derived therefrom with alternative investment opportunities available.

- The evaluation of the value of assets, etc by the banking and financial industries in their decision-making processes and the evaluation of sound credit risks whereby they require to evaluate the value of security offered or available.

- The investment community which includes insurance companies, pension funds and stockbrokers are constantly having to evaluate alternative investment opportunities.

- Anyone considering the acquisition or disposal of an asset.

- In matters of litigation such as divorces in order to determine a fair and equitable division of assets.

The investor must always consider the risks attaching to his investment and satisfy himself that they are justified by the investment return expectation achievable on his investment. Furthermore the investor requires to be aware of whether and how his investment's value can be improved or destroyed. Should he be a purchaser or seller, or should he expand? Very often the answers to many of these ponderables are contained in the tax consequences relating to his actions. For example, a sale could result in such enormous recoupment consequences as to substantially diminish the resultant funds available for investment into an alternative investment, that a disposal of the asset cannot even be contemplated.

In summary, valuations may be classified under these main headings as follows:

- *Valuation advice,* in respect of the value to be attributed on acquisition or disposal of assets in a business.

- *Appraisal,* in respect of an independent valuation (e.g. to express an opinion on the 'fair market value' in terms of Section 5(i)(f) of the Estate Duty Act, 1955, as amended).

- *Arbitration,* in order to assist to resolve differences between two or more parties.

The responsibilities and instructions under which the valuer is to act should always be clearly defined in writing and the following matters should be clearly defined:

a) The purpose of the valuation, as this may determine the valuer's approach and may have some influence on the final result. This requirement recognises that different circumstances may require the application of different rules. For instance the special provisions relating to a valuation for estate duty purposes make such a valuation one of artificially modified rules, varying the value from that which may have been arrived at by the same valuer under normal

circumstances. This being so, the valuer should clearly record that the valuation was made for the special estate duty evaluation purpose, and is not necessarily appropriate for any other purpose.

b) The valuer's functions and responsibilities, setting out clearly for whom he is acting and if for more than one party whether in the same capacity for all the parties.

c) The details of what is to be valued and whether or not it comprises a controlling or minority interest.

d) The method of valuation, if predetermined by agreement or negotiation in order that the valuer may ensure at an early stage that such method is reasonable, workable and acceptable to all the parties who are going to make use of the valuation.

e) Details of any instructions or agreements arrived at between the parties concerned in respect of any adjustments to be given effect to or not to be given effect to.

f) Instructions with regard to the use of other expert advisers.

g) Instructions if any with regard to any predetermined values of underlying assets such as stocks, etc.

DEFINITIONS RELATING TO VALUATIONS

"CAPITALISATION RATE"

- Whether in terms of earnings or dividends represents the return on investment expected by the buyer and the seller.

"DIVIDEND YIELD"

- Is the ratio which actual dividends paid to shareholders bears to the share price.

"EARNINGS YIELD"

- Is the ratio which actual earnings attributable to shareholders bears to the share price.

"MAINTAINABLE PROFITS"

- (as defined by R E Tonkin in the January 1967 edition of The Chartered Accountant in Australia):

  "The portion of the profits already achieved (as adjusted) which, at the date of valuation, should be reasonably capable of being maintained. It does not mean the potential future profits of the company - whilst a prospective buyer, may, in negotiation be prepared to pay something for possible future benefits, he would be a brave (or rash) valuer indeed who based his valuation on expected future profits higher than any achieved to date."

"PRICE EARNINGS RATIO or PE RATIO"

- Is the term for the number of years' earnings represented in a share price. This term is most commonly used in relation to shares quoted on a Stock Exchange.

VALUATION - NOT AN EXACT SCIENCE

The process of valuation is an informed opinion making use of facts, figures and other information relative to the asset being valued. It is in part science and part an art, in that valuations require both calculation and judgement.

In the case of Pietermaritzburg Corporation vs. South African Breweries Ltd - (1911) AD 501, the court recognised that only approximate results are obtained from a process of valuation.

In the case of Gold Coast Selection Trust Ltd vs. Humphrey, Inspector of Taxes - (1948) 2 ALL ER 379, Viscount Surion in the House of Lords said,

> "Valuation is an art, not an exact science. Mathematical certainty is not demanded, nor indeed is it possible."

In Estate Duty Case No.1 - (1959) 23 SATC 362, James J, in fixing the values of shares, approved of the dictum that,

> "The application of [valuation] principles is not a matter of pure mathematics, and there is room for wide differences of opinion as to the relative weight to be given to each of the several factors in the circumstances of any particular case."

In the case of Dean vs. Prince and Others - (1953) 2 ALL ER 636, the court remarked that there was no rule of thumb or accounting principle which fixes or limits the possible basis of calculation to be adopted in valuing shares.

Similarly, and because of the above it is obvious that, dependent upon how the valuator of shares in a company, or of any separate asset, considers each element of information which he has available

in respect of that which is being valued, a diverse range of valuations may be obtained from different valuators. There are many relevant factors which valuators should give their thorough consideration to, and very often it is found that the taxation implications of the transaction under consideration, as well as those arising from previous transactions, decisions or intentions, are overlooked or given insufficient attention by valuators.

In the case of Pietermaritzburg Corporation vs. South African Breweries Ltd - (1911) AD 501, the Appellate Division laid down the important fundamental principle that in making a valuation there must be taken into account,

"every circumstance which would be likely to affect the minds of intending purchasers."

In Winter and Others (Executors of Sir Arthur Munro Sutherland (deceased)) vs. IRC - (1961) 3 ALL ER 855, shares were to be valued in terms of the relevant legislation, by reference to the net value of the assets of the company. The company's assets included ships in respect of which substantial depreciation allowances had been allowed for income tax purposes. The valuation of the ships at their then market value would give rise to a substantial recoupment of the previously allowed depreciation allowances, and the question for consideration by the court was whether taxation on those recoupments should be taken into account in valuing the company's net assets. The House of Lords decided that such taxation should be taken into account.

The same principle would apply in South Africa in similar circumstances, or in fact, in any circumstances where previously deducted amounts are effectively recouped. This subject is dealt with in greater detail below.

Even where shares to be valued are shares in a public company quoted on a stock exchange, in respect of which there is normally no difficulty in arriving at a value, there being a ready market for

such shares and their value normally being the market price, the purchaser, seller and valuer must be aware of the background information relative to those shares, as those shares may have been from a bonus share issue out of distributable reserves of the company, and on a redemption of those shares at any time in the future, an income tax liability may arise. This would be the case where upon redemption of the shares or the liquidation of the company, to the extent thereof that the revenue reserves were applied in issuing the shares, a dividend would be deemed to arise in terms of Paragraph (c) of the definition of "Dividend" in Section 1 of the Income Tax Act.

With the promulgation of the 1990 Income Tax Act, dividends received on or after 1 March 1990 by persons resident or carrying on business in the Republic of South Africa are now exempt from taxation in terms of Section 10(1)(k) of the Income Tax Act.

LARGE BLOCKS OF QUOTED SHARES AND THE BLOCKAGE DOCTRINE

The blockage doctrine arises with the need to determine the proper value of large blocks of quoted shares in relation to normal trading volumes.

The question of an allowance or an adjustment for blockage has occurred in only one known and reported South African case.

In Lace Proprietary Mines Ltd vs. CIR - (1938) AD 267, 9 SATC 349, the question arose as to how, in a certain public company quoted on the Johannesburg Stock Exchange, one million shares should be valued. In finding that the determination of the value of the shares for tax purposes is a question of fact, the court went on to say that,

> "the value of the shares on the (relevant date) must, of course, be ascertained by enquiring what price could have been obtained for them, by adopting some reasonable method of sale on that date. To throw the whole million shares on the Johannesburg market on a given date would obviously be the worst possible way of gauging their value. Both common sense and the evidence suggest that the quotation would become fictitious or nil long before the major portion of the shares were sold ... there are obviously other methods of effecting a sale of shares wholesale than by throwing them all on the open market. What has to be looked for is a person who is willing to buy wholesale at a price under the retail price of the stock exchange quotation. He would get his profit over a period by retail sales. Such buyer would certainly be influenced by the stability and firmness of the stock exchange daily quotation and would normally buy at something under that quotation."

The above however, does not preclude a deceased estate holding a large parcel of a quoted share, dumping that share onto the market with a consequent drop in the market price of the share, even if an associated purchaser purchases the share parcel. Provided the sale took place through the open market in a bona fide purchase and sale, the shares are to be valued in the deceased estate, for estate duty purposes, at the price realised by such sale (Section 5(1)(a) of the Estate Duty Act, 1955, as amended).

The application of this provision may be of significance where there is a drop in the market value of quoted shares after the date of death of the deceased, but prior to the estate being wound up. In such circumstances it would be propitious for the executors to sell such quoted shares so as to obtain lower valuations for estate duty purposes, where the estate is dutiable. The heirs in the estate can themselves repurchase the same shares through the stock exchange, the dealing costs being substantially lower than the saving in estate duty.

Furthermore the House of Lords in the case Craddock vs. Zero Finance Co. Ltd (1944) 1 ALL ER 566, recognised that market quotations relating to small quantity transactions are no guide to the value of a large block of the same shares.

There are a number of Australian cases in which their courts have made allowances for blockage. In one such case, the case of Executors of the Estate of the Late Bruce-Smith vs. Federal Commissioner of Taxation - (1973) 4 ATR 148, it was however pointed out that a blockage allowance would not be appropriate where the block of shares to be valued confers control over the company.

MAJORITY AND MINORITY SHAREHOLDINGS

Under normal circumstances a majority shareholding in a company which confers voting control should be valued by reference to the value of the net assets of the company - McConnell Trustees vs. CIR - (1927) SLT 14, due allowance being made where appropriate for all tax liabilities including such tax liability, if any, which would arise in the hands of a shareholder on the distribution of the company's reserves upon its winding up, including any such reserves as may have been applied to the issue of share capital by way of bonus issues.

Where a minority interest is held, a valuation based on the net value of the company's assets is appropriate if the company has disposed of its business and is in the course of being wound up.

Where a minority holding in a trading company is being valued, the paramount factor in fixing the price which a hypothetical willing purchaser would pay to a hypothetical willing seller is usually based on the estimated dividend yield. In such a case, the asset portion indicates the degree of security which the purchaser may expect. Where the asset backing is high a purchaser may be prepared to accept a lower return than he would ordinarily require, particularly if the assets were likely to appreciate in value.

In ITC 932 - (1961) 24 SATC 341 the taxpayer received a minority shareholding in a private company in consideration for services rendered. The accountant called on behalf of the taxpayer surprisingly valued the shares in question by reference to the underlying value of the company's assets. The president of the court considered that the correct way to value shares in a private company was by reference to the break-up value of its assets. It is respectfully submitted that both the accountant and the president of the court were incorrect in their bases of valuation of a minority interest in this instance. Although, in my experience, accountants often are found to value minority

interests in this manner, making some allowance, usually 10 or 15 per cent, for the fact that the shares being valued constitute a minority holding, I respectfully submit that this method of valuation has no support in the legal precedents other than the doubtful authority of ITC 932. In my opinion the shares should have been valued by reference to the dividend yield the shareholder could reasonably expect the company to maintain.

THE CONCEPT OF VALUE

Brandeis J in the case of Southwestern Bell Telephone Company Ltd vs. Public Service Commission 262 US 276 at 310 (1923) remarked that "value is a word of many meanings". Some of the concepts of value which were examined in "The Valuation Of Property: A Treatise On The Valuation Of Property For Different Legal Purposes", by J C Bonbright (1937) are:

Value to the owner

Fair price

Forced sale value

Replacement value

Hypothetical sale price as between a willing purchaser and a willing seller

Hindsight value

Justified value as would prevail in an intelligent market or in a market free from the abnormalities of a panic or a boom

Warranted selling price

Insurance value

Mortgage value

In fact, S L McMichael in the fourth edition of "McMichael's Appraising Manual" lists some fifty-four concepts of property valuation.

In the case of Pietermaritzburg Corporation vs. South African Breweries Ltd (1911) AD 501, the term 'value' had to be determined where the valuation of land for municipal rating purposes was in dispute. The court held that in the absence of any statutory direction as to how the valuation was to be fixed, the proper standard of value was the market value and "the value of an article is, as a

general rule, what it will fetch". The court rejected any concept of value determined by reference to cost or the asset's utility to its owner and after considering many writings on the subject concluded that the ordinary meaning of the term 'value' is the temporary or market value.

Over the years the fundamental principles laid down in Pietermaritzburg Corporation vs. South African Breweries Ltd (1911) AD 501 have been followed in numerous cases which have come before both the Provincial Divisions as well as the Appellate Division of our courts.

In the case of Novic and Another vs. Comair Holdings Ltd and Others (1978) (4) SA 671 Coleman J in referring to the test of value held that:

> "and by that I mean market value in the sense of the price which the assets under consideration would fetch in a bona fide sale between a willing buyer and a willing seller, both of whom are reasonably well informed about the transaction, and neither of whom is under extraordinary pressure to buy or to sell, as the case may be".

The same general principle of valuation as that stated by Coleman J is found to apply in many other worldwide jurisdictions, including the United Kingdom and the United States of America (see ALR, 2nd edition at 783).

PRICE/EARNINGS RATIOS AND RELATED MARKET VALUES

Companies with high price/earnings ratios are generally able to acquire companies with lower price/earnings ratios and obtain an immediate increase in earnings per share, despite the fact that they pay a premium with respect to the market value exchange ratio. By acquiring sufficient companies over a period of time in this manner, a company could increase its earnings per share steadily and, to the extent that the market place values this illusory growth, the price/earnings ratio of the shares may actually increase. As a result, a company may so increase shareholders' equity appreciably through acquisitions. However, it is generally unlikely that the market will continually raise the price/earnings ratio of a company that is unable to demonstrate growth potential in ways other than from acquiring companies with lower price/earnings ratios. The acquiring company must demonstrate its ability to manage the companies it acquires if the benefits of acquisitions are to be lasting.

Market values are a major factor in all mergers or acquisitions. Over time and in differing degrees, market values fluctuate so that it is not easy to assess accurately the appropriate value of a company. Because of such fluctuations, some companies vary their pursuit of acquisitions in keeping with the price of their shares. When their price is high they may become aggressive in their pursuit for acquisitions. When it is relatively low such activity ceases. Such timing for an acquisition or merger can therefore be a factor of paramount importance to an acquisitive investor.

THE NEUTRAL IDENTITIES OF THE PURCHASER AND SELLER

In valuing shares and other property the courts have generally ignored the particular identity of the owner whose property is being valued, and have also ignored the identity of any specific purchasers, except that the requirements of a particular purchaser may influence the price which a hypothetical neutral purchaser may be prepared to pay.

In the case of Bradford on Aron Assessment Committee vs. White (1898) (2) QB 630 this general principle was considered, where the effect on the value of a property which had a special value to a particular buyer was before the court. The court stated,

> "I do not think that it is right to say that the competition between brewers should be wholly excluded from consideration, but the special prices which they may give, owing to personal considerations, and not on account of the value of the premises, should be excluded except so far as the possibility of such special prices being obtained raises the market value generally."

In the case of Ashcroft, Clifton vs. Strauss (1927) 1 Ch 313, a German subject, who was a shareholder, was because of the war between Britain and Germany, disqualified from selling shares owned by him in British companies. On the German shareholder's death during the war, his executors were similarly disqualified from selling or transferring the said shares. The court rejected the argument by the executors that the market price of the shares should be discounted or depreciated because the shares were the property of an alien enemy. The court held that the shares had to be valued disregarding the fact that the shareholder was incompetent to sell or transfer the shares at the valuation date.

Similarly, in a case where there was an understanding between a deceased shareholder whose shares were to be valued, and his son, that the shares would only be disposed of to the son and to no-one else, the court disregarded this arrangement and proceeded to value the shares on the basis of a hypothetical seller who would be unencumbered by any scruples in disposing of his shares to an independent outsider in Re Samuel Thornley - (1928) 7 ATC 178.

In the cases of IRC vs. Crossman and IRC vs. Mann heard jointly before the House of Lords - (1936) 1 ALL ER 762, where the Articles of Association discriminated between male and female shareholders, the court held that it was incorrect to attribute different qualities and characters to the shares held by the men and the women - IBID 778.

Furthermore, in the Crossman case referred to above, the question was raised as to whether cognizance should be taken of the fact that a trust company had indicated its willingness to pay a price higher than the ordinary market price for the shares in question because of certain attractions which the prospect of being on the share register held out for the trust company. The valuing accountant "did not exclude anybody or include anybody in particular" as a potential purchaser and the House of Lords agreed with this procedure - IBID 778.

The wartime case of Short vs. Treasury Commissioners - (1948) AC 534 is interesting in illustrating the principle of attributing a neutral identity to the parties. The shareholders at the time were compelled under wartime regulations to dispose of their shares to the British Government, compensation being payable at "not less than the value of those shares between a willing buyer and a willing seller". The sellers were all minority shareholders. The House of Lords held that the shares had been correctly valued parcel by parcel using principles of valuation applicable to minority shareholdings without reference to the fact that the purchaser was acquiring the entire issued share capital. Thus the purchaser's identity had been ignored and had the shares been valued by reference to the value of the whole undertaking, the price payable would have been significantly more than the price paid by the British Government.

SOME FACTORS AFFECTING VALUATIONS

In preparing an evaluation of the worth of a business or assets in monetary terms, many factors need to be considered, some of which are:

1. PROFITABILITY

Profitability is the capability of the business or asset to produce on an ongoing basis income in excess of the expenses in running or maintaining the business or asset.

2. RISKS

The commercial risks attaching to the business or asset are of great importance.

3. GROWTH POTENTIAL

Unless there is a potential for the growth in demand for the product or services offered, and an increase in profitability for the investor, a valuator may have to provide for additional safety factors to be included in his valuation.

4. FAIR MARKET VALUE

Fair market value in the minds of uninvolved persons if available needs to be considered. A regular assessment of the viability of continuing to hold an investment requires a reasonable evaluation of fair market value, however notional or subjective such value may be.

5. OPEN MARKET CONDITIONS

Open market conditions may be influenced by:

a) the availability of several purchasers or sellers

b) product or services knowledge

c) product or service comparisons

d) the rationality of the market

e) South African and international conditions such as:

- the political atmosphere
- Exchange Control regulations
- inflation
- legislation
- the general economic atmosphere and availability of funds for investment

6. TAXATION

The effects of taxation on the profitability of the investment must be known. Some of the questions to be answered are: what tax opportunities are there to encourage such investment and are these achievable? Are there special allowances or concessions and what is their effect on the profitability of the investment? How will a sale or liquidation of the investment be affected by taxation, e.g. by recoupments, etc?

TAXATION IMPLICATIONS

In view of South Africa's relatively high tax rates, with the corporate tax rate at 48% and the maximum tax rate of individuals at 42%, tax considerations in the evaluation of an investment may significantly affect any investment decisions and the method to be adopted and the basis upon which any acquisition or sale is to be structured, and, accordingly the valuation to be placed thereon. Very often, it may be found, that if all the tax implications were to be properly and carefully considered and investigated during the valuation and deal structuring process, they may well become deciding factors as to whether or not a transaction should be pursued, or if pursued, whether or not the transaction should be structured in some other manner, so as to achieve, under the circumstances, the best possible commercial results for all the participants.

In my opinion the taxation considerations relating to a valuation and any resultant investment decisions of acquisitions, sales or mergers are all important and vital. They must be thoroughly examined by all those concerned at every stage of any negotiations and the structuring of a deal, and, not only after the transaction has been finally concluded to see what might have been missed in the valuation and negotiation stages.

Far too frequently it is found that a transaction has been concluded without adequate or any consideration of the taxation consequences which may present themselves, and only at a later date are the tax effects stumbled upon. Everyone is then called in to attempt to find a solution, generally placing someone in an embarrassing situation. Very often there is no solution, or, the one party who claims to have been aware of the problem and will not be faced with its resultant costs will not agree to any amendments in valuation or otherwise.

Such situations are unnecessary and unwarranted and are generally uneconomical. Thus in order to optimise a situation from a tax point of view from the start, all of the taxation implications relating to the entity, its assets and of any proposed transaction should be thoroughly investigated in the valuation stage and prior to the formal negotiation and conclusion of any deal in order that the transaction may be concluded in the most tax efficient manner for all the parties concerned. This also ensures that there is no necessity to reopen well advanced or even concluded negotiations in order to cater for the influences and effects of taxation on the transaction as and when information by chance comes to light.

Tax considerations may significantly affect the investment decision as to whether the assets and operations of a business should be acquired or sold, or whether the shares in that company, or the members' interest in a close corporation, or the beneficiaries' rights in a trust, should be acquired or disposed of.

Other than the economic viability of the transaction as a whole, the tax considerations may be as vital, if not more so, than any other factor for consideration in evaluating the value of an asset or business entity, irrespective of the purpose of such valuation.

The tax implications may be numerous and material in value, some being of greater importance to a transaction than others. In the more complex situations the multitude of taxation considerations required may be likened to a minefield, as there is no automatic and scientific means of ensuring that all such tax implications that may be addressed in respect of any transaction will have been adequately considered.

Such tax considerations will always have an effect in determining the value to be placed on the subject matter of the transaction and the manner in which the resultant purchase consideration should be paid or financed.

The sections of these Acts relevant to the valuation of assets and the acquisition or disposal of assets are unfortunately not collectively grouped nor identified within these Acts for ease of reference. Numerous sections which may impact on valuations and transactions related to or arising therefrom are spread throughout those Acts and those involved need to be aware of their existence and implications. It is thus important to ensure that persons with a good up-to-date working knowledge of the legislation and its effects and influences are entrusted to consider all the aspects necessary when undertaking any valuation upon which any investment or other decisions may thereafter be exercised.

Due to the complexity and vastness of the subject of whether an amount received or accrued is of a capital or revenue nature, I have not dealt with this aspect of taxation in any detail. To do so would result in research and a document probably equal to or even longer than this document. However, I must stress that the very important aspect of capital and revenue is one of the basic pillars upon which South African tax practice revolves and in this regard I must point out that the majority of South African tax cases heard by our courts has in some manner or other had to consider the doctrines relating to capital and revenue.

In the case Re Montgomery et.al. and Shell Canada Ltd III DLR (3d) at page 116, it was held that in a large, widely-held corporation whose shares are actively traded the market value of the shares and not their 'asset value' is to be taken as their 'fair value' under Section 184(20) of the Canada Business Corporations Act, 1974-75-76 (Can.), 633, for the purpose of compensating dissenting shareholders.

Determination of the asset value of shares in a large multi-national corporation would involve a very costly appraisal. Further, the asset value is largely irrelevant in the case of a large corporation with no prospect of its winding-up; moreover, the expenses and the tax consequences of a hypothetical winding-up would be impossible to calculate with any degree of certainty.

In the same Saskatchewan Queen's Bench case at page 122 it is stated by Estey J who is referring to the answer to a question posed in the examination by counsel for the defendants:

> "... that the resulting net asset value is not a figure which, in the event of a liquidation, would be available to the shareholder or any shareholder because it does not take into account the fact that if the company was liquidated, the enormous amount of tax that would have to be paid by the company upon the liquidation both of such fixed assets as refineries, and other assets such as reserves, before any funds would be available to shareholders."

Accordingly, it can be seen that the courts have recognised taxation as a major factor in arriving at a valuation.

PARTNERSHIPS - AGREED VALUES

In CIR vs. Estate Whiteaway - (1933) TPD 486, 6 SATC 188, CIR vs. Estate Kirsch and Others - (1951) (3) SA 496 (A), 17 SATC 412, and Estate Robottom vs. CIR - (1961) (1) SA 33 (C), 24 SATC 56, our courts had to consider the implications of agreements entered into by deceased persons in terms of which shares or partnership interests were to be sold after the death of the deceased at predetermined values. The court held in both the Robottom and Whiteaway cases that where a partnership agreement provided that on the death of a partner the surviving partner should purchase the interest of the deceased partner in the partnership at the valuation set out by the agreement, it was incorrect to value for estate duty purposes the deceased partner's share in the partnership by reference to the amount of the purchase price fixed by the partnership agreement.

The same principles were applied in the case of CIR vs. Estate Kirsch and Others - (1951) (3) SA 496 (A), 17 SATC 412, where the property in question that was subject to valuation, was shares in a private company. During his lifetime, the deceased had entered into an agreement with two others in terms of which they were obliged to purchase from the deceased's executors the deceased's shares in a company at a fixed price. That fixed price was ignored for the purposes of valuing the shares for estate duty purposes.

In practice, the Commissioner for Inland Revenue does not require the inclusion of the value of goodwill, if any, in a deceased partner's estate for estate duty purposes except to the extent that there may be amounts actually owing or paid to the deceased estate in respect of goodwill or to the extent that goodwill has been recognised as an asset in the partnership. The same principle applies to a professional company carrying on a professional practice authorised by the body governing such profession. This practice, however, does not extend to activities of a professional practice carried

on in a company or close corporation outside of such specific governing body's authorisation or legislation. For example, an investment company or commission-earning company carried on by the partners of a professional practice, will have to be valued in the normal manner and goodwill, if any, would have to be valued.

SHARES NOT QUOTED ON THE STOCK EXCHANGE

As a result of the decisions in CIR vs. Issacs, N.O, (1960) (1) SA 126 (A), 23 SATC 142, and CIR vs. Estate Adelson (1960) (1) SA 418 (A), 23 SATC 166, Section 5(l)(f)(bis) of the Estate Duty Act was introduced in 1960. This section provides that in the case of shares not quoted on a stock exchange the value shall be determined on the basis of the value in the hands of the deceased at the date of death subject to the following provisions:

a) No regard shall be had to any provisions in the Memorandum and Articles of Association restricting transferability or determining the value of the shares of the deceased.

b) If upon a winding-up the deceased would have been entitled to a share in the assets to a greater extent pro rata to shareholding than other shareholders, no lesser value shall be placed on the shares than the amount to which the deceased would have been entitled to on a winding-up.

c) No regard shall be had to any provision or arrangement varying the rights attaching to any shares on account of the death of the deceased.

d) Account shall be taken of any power of control exercisable by the deceased in the company whereunder the deceased was empowered to vary or cancel any rights attaching to any class of shares in a manner so as to benefit himself.

PRACTICAL ASPECTS OF VALUATIONS

Very often Articles of Association, partnership agreements and other commercial agreements provide for valuations to be undertaken by auditors without any specific instructions about the method of valuation to be adopted.

This places an extremely onerous responsibility and burden upon the auditor who may adopt a method or principle of valuation never contemplated by the parties for whom the valuation is to be carried out.

It is accordingly suggested that whenever provision is made in any agreement or document, for an auditor's valuation, guidelines should be provided for the auditor to follow. The following guidelines are an example:

a) Where the holding to be valued is a minority holding:
   - whether the valuation should follow minority valuation principles or whether the holding should be valued at the proportionate share of the value of the entire company or entity;
   - whether or not a deduction is to be made for the fact that the holding being valued is a minority holding.

b) Where the holding being valued is valued on the basis of the entity's net assets:
   - whether or not any deduction should be made for the tax liabilities that may arise on:
     - the distribution of the company's distributable reserves on a winding-up;
     - the redemption or repayment of share capital issued by way of bonus shares out of a company's distributable reserves.

c) Whether or not any value is to be placed on goodwill and if so, consideration should be given to setting out the method to be used in determining the value of such goodwill, if any. The same would apply to trademarks, trade names, copyrights, etc.

d) Where the valuation is to be made by way of reference to the net assets of the entity, consideration should be given to setting out clearly the method to be applied to the valuation of all specific major assets whose original costs or book values are likely to be irrelevant at the time of the valuation, e.g. the current market values of fixed property, hire purchase debtors, plant and machinery, dies and patterns, stock in trade, etc.

e) How the entity's 'equity' in leased assets is to be dealt with.

f) How, if at all, the entity's estimated liabilities for 'deferred taxation' are to be accounted for or adjusted for.

g) How taxation generally is to be accounted for, especially taxation arising from recoupments on the revaluation of assets, taxation on the reversal of stock and other reserves, tax allowances still to be allowed against future income (e.g. farming capital development expenditure, assessed losses, etc).

h) Any other matters of specific importance to the entity where it would be appropriate to furnish guidelines to the auditors.

Furthermore, it must be recorded that in many instances the auditors only become aware of the onerous valuation provisions after they have been concluded, signed and sealed. It would always be

wise for the person drafting such documents to provide a procedure to be followed in the event of an auditor declining to make a valuation when called upon to do so. This situation may arise for a multitude of reasons, particularly where the auditor may be of the opinion that he may not be able to provide an unbiased independent valuation due to his intimate association with the entity and the other parties to the valuation.

ACQUISITIONS OR MERGERS THROUGH CHANGES IN SHAREHOLDINGS

"ACQUISITIONS"

Acquisitions occur when control over the assets or rights of one operation are acquired directly by the gaining of ownership of the assets or indirectly through the gaining of control of the entity which owns those assets.

"MERGERS"

Mergers take effect when two or more operations or businesses come under the control of a single entity while the ownership of the merged operations or businesses remains substantially the same as that of the ownership of the merging entities.

There is unlikely to be any change in the tax position of a target company to be acquired or merged with another through a change in shareholdings as the target company will generally continue to operate through the same taxable entity retaining its tax status and tax profile. However, a target company may after its acquisition be restructured and cease to trade as a separate entity or there may even be a major change in such company's trading activities. Changes such as these could have a resultant taxation effect on the target company.

The target company may have accumulated tax losses which could be endangered and foregone.

Each company in South Africa is taxed on its own taxable income and tax losses, both current and accumulated during previous tax years, may only be set-off against the company's own taxable income. The merging of banking institutions' operations in terms of the Banks Act does however provide, with the Minister of Finance's consent for the merger and pooling of the assessed tax losses of such institutions.

In certain foreign tax jurisdictions, what is known as 'group relief' is available whereby losses made by companies in a group may be set-off against profits made by other companies in the same group. This concept is not applicable in South Africa, each taxable entity being treated separately.

Furthermore, in certain circumstances South African law 'ring fences' certain categories of losses or expenses so that such losses or expenditure may only be set-off against profits from the same trade earned by the same taxpayer. For example, accumulated farming losses from the write-off of livestock - (First Schedule, para.8(i)), or farming capital development expenditure, may only be set-off against farming income of the same taxpayer - (First Schedule, para.12(i)).

A farmer's expenditure referred to as capital development expenditure and dealt with in para.12(i) must be incurred by the farmer taxpayer in connection with his own farming operations and this special group concession is therefore interpreted strictly - (Ernst vs. CIR (1954) (I), SA 318 (a), 19 SATC 1; ITC 28 (1924) 7 SATC 251; ITC 885 (1959) 23 SATC 336).

The South African tax legislation does however apply in a very limited manner 'group relief' to shipping companies and certain wholly-owned subsidiary companies entitled to economic development area incentives. For the purposes of this study, I do not, however, intend to deal in any detail with either of these two specialised areas of taxation.

Once a transaction arising from a valuation will have taken place, it may be intended that the target company, or some other group company, is to become dormant, cease to trade, or even substantially change the nature of its business. Should that company have a tax loss at such time, the benefits of such loss may be lost to the company and the group forever. It is thus important for the valuer and all other parties to the transaction to understand and be aware of all the circumstances which could result in an assessed tax loss being foregone.

The subject of assessed losses is dealt with on page 43.

SOME IMPLICATIONS OF THE ACQUISITION OF ASSETS, LIABILITIES AND TRADING OPERATIONS AS COMPARED TO THE ACQUISITION OF SHARES

The valuation and sale of assets which have in the past given rise to income tax allowances which are recoupable must be carefully considered. The subject of the taxation of recoupments is dealt with on page 88.

Unless an entire business is acquired as a going concern with all its trading assets and liabilities, other than debtors and cash resources, the acquirer of such business would have to pay General Sales Tax (GST), presently payable at the rate of 13% of the gross value of the assets. In addition, if there is immovable property to be transferred the costs of transfer duty (approximately 5%) and conveyancing (approximately 1%) must also be considered in valuing such assets. With the introduction of value-added tax (VAT) at the rate of 10% in place of GST, similar provisions were introduced.

In comparison, a transaction involving company shares where the underlying assets remain the same as would be the case in the above paragraphs, stamp duty on the net value of the shares being transferred, at the rate of 1,5% of the value of such shares, would be payable and there would be no liability for taxation on recoupments, nor in respect of GST (and more recently VAT), transfer duty or conveyancing costs, although there will be a change in the overall control of those assets through the change in control of the shares. Due to the possible value of liabilities taken on the net value of a share transaction may be very small whereas the costs associated with an acquisition of assets being based on the gross value of those assets may be substantial.

For example, assume that a company's financial statements reflect the following:

Capital Employed

Share capital		10 000
Retained income		90 000
Shareholders' funds		100 000
Long term loans		1 200 000
		R1 300 000

Employment of Capital

Fixed assets		1 500 000
Current assets		750 000
- Stock on hand	700 000	
- Cash at bank	50 000	
		2 250 000
Less: Current Liabilities:		
- Creditors		950 000
		R1 300 000

Assume that the present market value of the fixed assets is R2 000 000 and the original cost of those fixed assets was R2 200 000, the difference between cost and book value having been allowed as a deduction for tax purposes.

The costs that would be incurred in the event of a purchase and sale of the assets and liabilities of the company and assuming an income tax rate of 48%, would be as follows:

a) If the assets, liabilities and business were not sold as a going concern:

i) If the fixed assets comprised fixed property:

- Transfer costs 5% of R2 000 000		100 000
- Conveyancers' costs 1% of R2 000 000		20 000
- Tax on recoupment of R2 000 000 - R1 500 000 @ 48%	240 000	
	R240 000	R120 000

Total costs - R360 000.

ii) If the fixed assets comprised movables:

- GST @ 13% of R2 000 000		260 000
- Tax on recoupment of R2 000 000 - 1 500 000 @ 48%	240 000	
	R240 000	R260 000

Total costs - R500 000.

(With the introduction of VAT in 1991 the GST costs at 13% will be replaced by VAT at 10%).

b) If the assets, liabilities and business were sold as a single going concern:

i) If the fixed assets comprised fixed property:

- as in (a) (i) above	R240 000	R120 000

Total costs - R360 000.

ii) If the fixed assets comprised movables:

- GST (and now VAT)		Nil
- Tax on recoupment of R2 000 000 - R1 500 000 @ 48%	R240 000	
	R240 000	Nil

Total costs - R240 000.

c) If the transaction is by way of the transfer of shares:

- Stamp duty on the value of the shares:

Value of shares	
Shareholders' funds	100 000
Plus surplus on revaluation of fixed assets	500 000
	R600 000
1.5% Stamp duty on R600 000	R9 000

Total costs - R9 000.

Note: For the purpose of this exercise it has been assumed that no allowance is necessary for:

a) Taxation on retained income

b) Deferred taxation on potential surplus on realisation of fixed assets - (48% of R2 000 000 - R1 500 000) = R240 000

It can immediately be seen that on a rather simple transaction the combinations of costs, dependent upon the structuring of the transaction can be vast. In addition, the immediate cash requirements of (c) above are minor in comparison to those of the other alternatives.

On a transaction requiring a net purchase consideration of R600 000 the costs between purchaser and seller ranged from a total of R9 000 to a total of R500 000 (see above). Such vast amounts can very often destroy a transaction's potential success even before it gets off the ground.

A valuer who does not draw such differences to the attention of his principle will, in my opinion, be failing in his duty.

The provisions of Section 30 of the Income Tax Act are:

"When the business of any person, other than a person carrying on the business of insurance or any other person in respect of whose business outside the Republic special provision is made under this Act, extends to any country outside the Republic, the taxable income or assessed loss of such person shall be a sum which bears the same ratio to this total net profits or total loss from all sources, as the case may be, calculated in the manner provided in this Act for the determination of taxable income or assessed loss, as his assets in the Republic bear to his total assets; provided that if accounts satisfactory to the Commissioner can be furnished, the Commissioner or the taxpayer may claim that the actual taxable income derived from sources within the Republic, or loss incurred within the Republic, shall be assessed in the manner otherwise provided in this Act."

Accordingly, in valuing such a business, a thorough consideration must be given as to whether the assets of a business extending beyond the borders of the Republic should be acquired, or whether the shares in the company controlling the business should be purchased, and the values at which such assets or shares may be acquired. Section 30 of the Income Tax Act presents some interesting planning opportunities in the correct circumstances, and when applied with thought, especially where there is a significant difference in the tax rates of the countries involved.

Section 28 bis of the Income Tax Act provides that if the Commissioner for Inland Revenue is satisfied that the circumstances warrant a concession, a company incorporated, managed and controlled in South Africa, referred to as the subsidiary, wishing to acquire all the assets and liabilities of a foreign company as a going concern, any taxable income derived, or tax loss incurred by the foreign company prior to the discontinuance by the foreign company of the said undertaking, may be transferred to the subsidiary company. In order to meet the requirements of the section the following conditions must apply:

i) All the assets and all of the liabilities of the foreign company relating to any industrial, commercial or other business of the foreign company in the Republic must be acquired by the subsidiary as a going concern, and

ii) at the time of the arrangement being implemented, all of the issued shares of the South African incorporated company, the subsidiary, must be held for its own benefit by the foreign company, or by another foreign, incorporated, managed and controlled company which was itself controlled by the foreign company, or that the arrangement was implemented in order to meet the requirements of Section 3 quat of the Insurance Act, 1943.

These provisions should always be carefully considered when acquiring assets or a business from a foreign company. In many instances of disinvestment from South Africa by multinational entities the provisions of Section 28 bis have been applied and the shares of the newly-formed subsidiaries were then disposed of to South African interests thus retaining the tax profile of the business and, in many cases:

a) protecting assessed losses of substantial amounts, and

b) avoiding the taxation of recoupments.

However, in certain instances these provisions were either overlooked or ignored and the foreign taxpayer either paid substantial taxation on disinvestment or lost forever substantial assessed losses in respect of which many a valuer and purchaser may well have attributed a value in valuing the business.

ASSESSED LOSSES

It is accepted tax and case law that if a company with an assessed loss does not trade during a financial year, it will be precluded from carrying forward any balance of assessed tax losses brought forward and the accumulated tax losses will be foregone forever.

In the case of S A Bazaars (Pty) Ltd v CIR (1952) 18 SATC 240 it was found that no set-off of losses incurred in previous years was permissable where the company had closed down its active business operations and no income was derived from the carrying on of trade.

The case ITC 664 (1948) 16 SATC 125(U) also dealt with circumstances where a loss was incurred during a period of trading and whether that loss could be carried forward and set-off against income from other sources in years in which no trading income was derived. The taxpayer's appeal was dismissed as he had neither traded nor received any income from trade.

However in ITC 777 (1953) 19 SATC 320(T) it was held that an assessed loss from a previous year could be set-off where no trading income had been derived, it being held that unsuccessful endeavours to let fixed property constituted the carrying on of a trade.

Furthermore, it must be borne in mind that where a company with an accumulated tax loss ceases one trade and commences an entirely unrelated trade, the set-off of accumulated tax losses against the income derived from the new trade will not necessarily always automatically occur. For instance, the company's taxable tax loss from mining activities may not be set off against income generated from non-mining activities. This may have the effect in the anomaly of a tax loss being generated

by one activity in the company while taxes are payable on some other activity within the same company. If this were to occur it would be of importance to ensure that the trade which had generated the tax losses was continued in some small manner at least, as its cessation could result in the loss forever of such accumulated tax losses.

In the case of New Urban Properties Ltd v SIR (1966) 27 SATC 175 it was found that a break in the continuity of carrying forward an assessed loss resulted in the denial of the balance of the assessed loss for set-off after such break.

When valuing a target company which has an accumulated tax loss it must be remembered that the value of any compromise gain received by the company resulting from a compromise made with the company's creditors, whereby its liabilities to its creditors are reduced or extinguished, provided such liabilities arose in the ordinary course of trade, will reduce the amount of the accumulated tax losses (Section 20(1)(a)(ii) of the Income Tax Act).

The compromise, if any, therefore should be limited to loan creditors and not trade creditors for goods or services rendered.

It must be borne in mind that although this provision of the Income Tax Act has in the main been applied to 'compromise offers' relating to companies, the provisions of the section relate to any taxpayer with an accumulated loss.

Applying the section can very often be extremely beneficial to a taxpayer if applied correctly.

Assume that a taxpayer has an accumulated tax loss of R100 000 from year 1 carried forward to the beginning of tax year 2. During tax year 2 he receives a benefit from a compromise with one of his

larger supplier creditors in terms of which that creditor agrees to reduce the amount owing by the taxpayer by an amount of R175 000 in respect of goods or services rendered in previous years and in respect of which they have had a dispute. Also assume that the taxpayer has R40,000 net trade income in tax year 2.

In applying the provisions of Section 20(1)(a)(ii) the R100 000 assessed loss at the commencement of the tax year should first be reduced by set-off of the current years net trade income of R40,000 to R60,000 and then to nil by a set-off against the R175 000 compromise benefit. The remaining R115 000 compromise benefit should remain tax-free in the hands of the taxpayer, this amount having been neither income received or accrued during the tax year, nor a recoupment of expenditure deductible in a previous year.

This principle was clearly dealt with in the well known case of CIR v Louis Zinn Organisation (Pty) Ltd (1958) 22 SATC 85.

Accordingly, the valuer must be fully aware of the manner in which any transaction arising in such circumstances may be constructed. A transaction may be structured in such a manner that there will be no effect on or reduction of the accumulated tax losses. However, should proper structuring not be given effect to and the provisions of Section 20(1)(a)(ii) be applicable and effective, the value of any assessed loss may be lost or severely reduced and this should be taken into account in any valuation which places any value on such accumulated tax losses.

Whenever a company which is to be valued or acquired has an assessed loss, the valuer or acquirer should always ensure that they are fully aware of the necessary action required to avoid the provisions of Section 103(2) of the Income Tax Act. A failure to be aware thereof could result in

the Commissioner for Inland Revenue succeeding in applying the provisions of Section 103(2) in disallowing the set-off of the accumulated assessed loss from future profits. The three requirements contained in the section which a valuer must be aware of are:

Whenever the Commissioner is satified that

i) any agreement affecting any company or any change in the shareholding in any company or in the members' interests in any company which is a close corporation,

ii) as a direct or indirect result of which income has been received by or has accrued to that company during any year of assessment,

iii) has at any time been entered into or affected by any person solely or mainly for the purpose of utilising any assessed loss or any balance of assessed loss incurred by the company, in order to avoid liability on the part of that company or any other person for the payment of any tax, duty or levy on income, or to reduce the amount thereof.

The set-off of any such assessed loss or balance of assessed loss against any such income shall be disallowed.

Generally, taxpayers have succeeded by being in a position to discharge the onus of proof by showing that although the transaction may well have the effect of avoiding or reducing tax, this benefit was merely an incidental or fortuitous benefit and not the sole or main purpose of the transaction. Sound commercial reasons, other than any tax-saving motivation should therefore be in existence justifying the acquisition of the company with its accumulated assessed tax losses in order to succeed in overcoming any attack by the Commissioner in terms of Section 103(2). In this regard it must

be recorded that the acquisition of the shell of a company with no underlying ongoing business or assets of value, other than an assessed tax loss is highly unlikely to escape the provisions of Section 103(2) of the Income Tax Act.

The moratorium in terms of the Taxation Laws Amendment Act 87 of 1988 provides for the exemption from transfer and stamp duties of certain transactions in terms of the group restructuring of fixed properties and certain other assets. Although this has been introduced to assist groups of companies to reorganise themselves and even achieve a divisionalised structure within a group, pooling group resources, no provision has been made for the transferring or pooling of tax losses between companies, and Revenue has made it clear that they were unlikely to approve of the transfer of assets or businesses generating profits into companies with accumulated tax losses in order to make use of such losses by means of setting-off such profits against those losses.

THE GENERAL ANTI-AVOIDANCE PROVISIONS OF SECTION 103(1)

In any valuation and the resultant acquisition or disposal transactions the valuer must at all times be fully aware of the provisions of Section 103(1) of the Income Tax Act, particularly where there is any intention to effect any transaction, and the effect of such intended transaction may be to postpone or avoid the liability for any taxes. The requirements of the section are onerous upon the taxpayer who must always be aware of the potential application of the section to any transaction, scheme or arrangement.

Generally, provided the taxpayer can demonstrate sound commercial reasons for the carrying out of the transaction in question, other than the avoidance or postponement of taxation, the Commissioner for Inland Revenue will find it difficult to apply the provisions of Section 103(1) of the Income Tax Act.

The provisions of Section 103(1) of the Income Tax Act are:

103.(1) Whenever the Commissioner is satisfied that any transaction, operation or scheme (whether entered into or carried out before or after the commencement of this Act, and including a transaction, operation or scheme involving the alienation of property) -

a) has been entered into or carried out which has the effect of avoiding or postponing liability for the payment of any tax, duty or levy imposed by this Act or any previous Income Tax Act, or of reducing the amount thereof; and

b) having regard to the circumstances under which the transaction, operation or scheme was entered into or carried out -

(i) was entered into or carried out by means or in a manner which would not normally be employed in the entering into or carrying out of a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; or

(ii) has created rights or obligations, which would not normally be created between persons dealing at arm's length under a transaction, operation or scheme of the nature of the transaction, operation or scheme in question; and

c) was entered into or carried out solely or mainly for the purposes of the avoidance or the postponement of liability for the payment of tax, duty or levy (whether imposed by this Act or any previous Income Tax Act or any other law administered by the Commissioner) or the reduction of the amount of such liability,

the Commissioner shall determine the liability for any tax, duty or levy imposed by this Act, and the amount thereof, as if the transaction, operation or scheme had not been entered into or carried out, or in such manner as in the circumstances of the case he deems appropriate for the prevention or diminution of such avoidance, postponement or reduction.

[Subsection (1) substituted by s 14(1)(a) Income Tax Act, 1978, in terms of s 21 of that Act, effective for the purposes of assessments in respect of normal tax and undistributed profits tax as from the commencement of years of assessment ending on or after 1 January 1979; as far as concerns other taxes imposed by the principal Act, effective from the date of promulgation of the Income Tax Act, 1978: 28 June 1978.]

TAX IMPLICATIONS ON VARIOUS PARTIES TO BE CONSIDERED WHEN VALUING A COMPANY

TAX IMPLICATIONS ON THE TARGET COMPANY

The target company will on an acquisition, generally retain its existing tax status and profile unless the business of the company is significantly restructured, or where the company ceases trading and has an assessed tax loss, such loss may be lost.

A change in the shareholding of the target company may also alter the company's status from that of a public company to that of a private company, or vice versa.

A change in the shareholding of the company may also result in the company becoming liable for or exempt from Undistributed Profits Taxes ("UPT") as a company whose holding company's principal business is mining is exempt from UPT, as is a company which is directly or indirectly controlled by non-residents who do not carry on business in South Africa - (Section 50(c) of the Income Tax Act).

Any company that was during any part of the year of assessment a close corporation is also exempt from Undistributed Profits Tax - (Section 50(aC) of the Income Tax Act).

Where the target company incurs any expenditure in an attempt to obtain a valuation of itself or to stave off the acquisition of the company, for any reason whatsoever, such expenditure would not be deductible for income tax purposes as such expenditure would not have been incurred in the production of income. Such expenditure is of a capital nature and not deductible.

Similarly, expenditure incurred by a company in giving effect to a reconstruction or a scheme of arrangement agreed to by the company's creditors and confirmed and approved of by the Supreme Court, is also in effect capital expenditure and not deductible when determining taxable income.

In most instances it will be found that companies incurring such expenditure do not separate out and highlight such costs as a single item, and as the expenditure is allocated to and included in the companies' other operating expenditures such as salaries, printing expenses, advertising, etc, the expenditure erroneously becomes deductible.

The intentions and actions of the directors and controlling shareholders is usually attributed to a company as being those of the company. The conclusion of merger, acquisition or disposal negotiations following upon a valuation may in appropriate circumstances infer a change of intention from capital to revenue in relation to certain assets with the attribution to the company of the intentions of the new shareholders or management. Extreme care must therefore be exercised to ensure that a merger or acquisition or the actions that follow do not amount to a change of intention relating to assets which may convert such assets which were previously categorised as a 'capital asset' becoming 'stock in trade' or otherwise of an income nature, the proceeds from the disposal of which would be taxable.

The question of intention and changes of intention and the tax consequences thereof is dealt with on pages 69 to 73.

Where trading stock consists of fixed property or shares in a company and such trading stock is disposed of in return for shares in another company, section 24A of the Income Tax Act permits a deferral of the taxation on the disposal of the original trading stock. Should the new shares, issued in exchange for the trading stock be disposed of, the taxation which was deferred in terms of the section becomes payable. Accordingly, following a merger or acquisition, the new shareholders

of a company must ensure that none of the shares held by a company acquired will, on disposal, attract such taxation, unless adequate provision both in any valuation and by way of cash flow has been made. This contingent tax liability has in the past been known to the writer to have been an extremely contentious point of negotiation in the valuation of a company. The tax liability may be of such amount as to hinder any disposal of such shares for fear of the tax payable.

Section 22(4) of the Income Tax Act may also give rise to a similar liability for taxation. That section permits, in the year of their acquisition, capitalisation shares, options or other rights to acquire shares in any company to be valued at no value for the taxpayer's trading stock for taxation purposes. The effect of this provision is therefore to subject to taxation upon their ultimate sale by the taxpayer, the full disposal proceeds of such shares or options held as trading stock. Once again, great care must be exercised in establishing the nature and source of such assets comprising trading stock and their tax values. In fact, such enquiry should also extend to such assets not necessarily categorised as trading stock, in valuing such assets, as there may well be an attack from the Commissioner for Inland Revenue as to the classification of such assets.

The provisions of Section 22A of the Income Tax Act apply where there is any scheme of arrangement or reconstruction of any company or its affairs (including the amalgamation of two or more companies and any other scheme) sanctioned by an order of court, as a result of which any company (the transferee) acquires from any other company (the transferor) any asset which was trading stock of the transferor, the following consequences result from such acquisition if:

a) no consideration measurable in terms of money accrued from the transferee to the transferor, or

b) a consideration accrued from the transferee to the transferor the money value of which was less than the market value of such asset on the date the transferee acquired such asset, namely:

i) the asset is deemed to be trading stock of the transferee and any amount received by or accrued to the transferee from the disposal of such trading stock, or the disposal of any interest therein, must be included in its income, whether such amount is derived in carrying on any trade or otherwise or is derived from a source within or outside the Republic.

ii) if no consideration measurable in terms of money accrued to the transferor from the transferee, then:
   - the cost of the trading stock to the transferee is deemed to be an amount equal to the cost price thereof to the transferor, and
   - the transferor is not entitled, in determining its taxable income for the year of assessment during which the transferee acquired such asset, to any deduction in respect of the value of such asset as trading stock.

This section thus deems trading stock involved in a scheme of arrangement or reconstruction to have been acquired by the transferee at its original cost to the transferor. Once again the provisions of this section may, under certain circumstances, impose a contingent tax liability on an acquiring company. Any such liability should, if material, be brought to account by a valuer when preparing a valuation.

TAX IMPLICATIONS ON THE SHAREHOLDERS OF A COMPANY BEING DISPOSED OF

The price requested by a seller may be significantly influenced by the fact of whether the proceeds receivable from a disposal of a shareholding will be taxable in the hands of the seller.

When minority shareholders are being paid out for their shareholdings a number of factors must be carefully considered in attempting to establish whether or not the consideration receivable will be taxable or not. The definition of 'gross income' in Section 1 of the Income Tax Act specifically excludes "receipts or accruals of a capital nature". Thus it is of great importance to a shareholder selling shares, to establish the intentions existent at the time of acquiring the shareholding, while it was held, and, also when it was being disposed of. The intentions of each shareholder, and particularly those of a minority shareholder as compared to a controlling shareholder may well have been quite different and therefore the tax position relating to one shareholder may be different to that of the next shareholder. Very often a minority shareholder may have little or no say in the manner by which, or price at which, his shares are taken from him. He may not even have been in the marketplace to sell but found himself being forced to do so. In such circumstances the proceeds are likely to be of a capital nature.

Where minority shareholders are forced to dispose of their shareholdings in terms of a formal takeover procedure in terms of a scheme of arrangement, or Section 321 of the Companies Act, the element of compulsion will be favourable to any shareholder wishing to prove that they had not embarked upon a change of intention at the time of disposing of the shares. This should assist in proving a capital intention. However, this element of compulsion would not assist a sharedealer unless he were able to show that the shares disposed of were from a block of shares held for investment purposes. Similarly, shareholders who had acquired their shareholdings in anticipation of a worthwhile offer being made to all minority shareholders, would not be assisted by the element of compulsory surrender of their shares.

A situation on the other hand may be that a company had for many years been managed and controlled by a major shareholder who now wishes to retire. In the hands of the major shareholder in such circumstances the consideration receivable for those shares is very likely to be categorised

to be of a capital nature. However, another shareholder, who is also a sharedealer or speculator, may have held a parcel of shares, a minority interest, which he had originally acquired and has held as a speculative investment. That minority shareholder is likely to be taxed on any amounts he may receive in consideration for his disposing of his shares.

Accordingly, at the valuation stage the proper consideration must be given to the questions of intention, change of intention and whether or not the shares or any other assets have been held on revenue or capital account as each of these factors may have taxation consequences which would impact on any valuation of the shares asset, or business under consideration.

The definition of 'gross income' in Section I of the Income Tax Act specifically includes the receipt of any annuity, in taxable income. Thus anyone disposing of shares or any other asset, particularly on capital account, must ensure that the payment of the consideration for the asset is not made in the form of an annuity which would be taxable. The subject of annuities has been dealt with on page 113.

Consideration for goodwill or as a restraint of trade payment will generally not be taxable in the hands of the recipient, such amounts being of a capital nature. However any such amount receivable which is in any manner linked to future profits, or varies according to future results, is likely to be deemed to be a revenue receipt and subjected to taxation in the hands of the recipient. Where the amount of the goodwill or restraint of trade payment has been calculated by reference to expected future profits, but has been fixed at a definite sum of money, which will not vary irrespective of the future results, then the receipt should be of a capital nature. Where the purchase price of any shares, including any goodwill, varies in proportion to profits, there is a possibility of that portion of the purchase price relating to goodwill, being deemed to be of a revenue nature in the hands of the recipient while the payer of such consideration will, unless a sharedealer or speculator, be deemed to have expended the amount on capital account.

A valuer and shareholders must carefully consider the implications of certain aspects of the definition of 'dividend' as set out in Section I of the Income Tax Act and the taxation or exemption from taxation thereof.

Paragraphs (c) and (d) of the definition of 'dividend' read together with provisos (iii) and (iv) to the definition require that the amount by which any consideration given to shareholders, upon a partial reduction or redemption of a company's capital, exceeds the cash equivalent of the amount by which the nominal value of the shares is reduced, or in the event of a reconstruction of a company, as exceeds the nominal value of the shares held by him before the reconstruction, be a dividend distributed.

If former shareholders are to receive as consideration or part consideration for the shareholdings, cash or any other asset from the company in which they held their shares, such distributions would be taxable as above. Paragraphs (c) and (d) of the dividend definition referred to above specifically refer to "so much of the sum of any cash and the value of any asset given to a shareholder ...". The nature of the asset so distributed, if any, is irrelevant and has no bearing whatsoever on its taxability.

In recent years many public companies have offered their shareholders the option of taking dividends in the normal manner or in lieu of such dividends, to distribute to such shareholders as may have so elected, capitalisation shares, thus giving the shareholder a greater stake in the company due to some shareholders taking traditional dividend distributions and foregoing their pro rata allocations of capitalisation shares.

Capitalisation shares are shares issued by a company, by way of a bonus award or otherwise, in such manner that its reserves, including any share premiums received, or unappropriated profits are in whole or part applied in issuing and paying-up such shares. An award of shares of no par value

without the company's stated share capital being increased by any transfers from reserves, share premiums or unappropriated profits does not constitute an award of capitalisation shares but merely a split of the existing shares. Furthermore, capitalisation shares awarded out of share premiums are excluded from the definition of dividend to the extent to which such shares have been paid-up by means of the application of the whole or any portion of the share premium account of the company. Should the portion of the share premium account used equal the nominal value of the capitalisation shares, there is no dividend, and if the portion of the share premium account be less than the nominal value of the capitalisation shares, only the difference constitutes a dividend. These rules apply irrespective of what the market value of the capitalisation shares is.

In terms of paragraph (b) of the definition of 'dividend' as contained in Section I of the Income Tax Act, the redemption of capitalisation shares, by a company not being wound up or liquidated, will attract taxation, the redemption being deemed to be a dividend, but subject to the exclusion of any share premium content as referred to above.

Similarly, paragraph (a) of the definition of dividend in Section I of the Income Tax Act applies to a company that is being wound up or in liquidation, and any profits distributed, whether in cash or in kind, other than of a capital nature, earned before or during the liquidation, constitute dividends.

It is therefore of importance for any valuer or acquirer of shares to be fully aware of the full history of the shares and that the provisions of paragraphs (a) and (b) referred to above will not adversely affect a shareholder. In this regard it is interesting to note that a shareholder in a public company is in most instances quite unaware of whether the shares he holds comprise of capitalisation shares or shares issued in the normal manner. Yet the contingent tax liability attaching to the capitalisation shares may, if properly taken into account, even on a deferred basis, cause those shares to be attributed a lower value than the other shares in the company. In this regard it may well be

advisable for the Johannesburg Stock Exchange to consider ensuring that capitalisation shares be categorised as such and that they be listed separately, even though the contingent tax liability may be so remote as to have no immediate value. Without much warning, a company may become restructured, or unfortunately suffer financial difficulties resulting in its failure and even liquidation and unsuspecting shareholders could be faced with unexpected substantial income tax liabilities.

A winding up or liquidation of a company means a winding up or liquidation in terms of the provisions of the Companies Act. A distribution by a company in anticipation of and then the company's deregistration is not a distribution in the winding up or liquidation as required in terms of the Income Tax Act. For the exemption from taxation as a dividend to apply to capital profits, or for such profits to retain their nature in the hands of a receiving company, such profits must be distributed during the winding up or liquidation procedure and not prior to or in anticipation of such procedure. There is, however, an exception to the rule and that is when either Section 40A or 40B of the Income Tax Act is applied. Detailed discussion in this regard will be found below.

A further aspect of a winding up or liquidation which may be of relevance is that where unrealised assets are distributed as part of a liquidation dividend, i.e. a distribution in specie takes place, such assets are distributed and taken into account by the liquidator at their cost or book value for tax purposes, irrespective of the market value of such assets, even if such assets constitute trading stock, the realisation of which by the liquidator would have resulted in revenue profits subject to taxation on distribution. An enhancement in value of unrealised trading stock is not a profit earned and only a sale of such stock by the liquidator could give rise to a profit.

In the hands of the recipient shareholder, the assets received in specie from a company in liquidation must be valued at market value to arrive at the value at which they were received. Accordingly, if any sales tax, transfer duty or stamp duty is payable on the change in ownership of the assets, such

tax or duty is payable on the market value. Furthermore, if the recipient shareholder is not a trader in the asset or commodity received but merely realises it to best advantage, and does not embark upon a trade, no tax liability should result from the gross proceeds of the disposal of such assets. Should the taxpayer have embarked upon a trade he would be entitled to deduct from the gross proceeds of the disposal, the market value of those assets on their acquisition by him.

The provisions of the Income Tax Act in this regard have been examined by the Margo Commission who specifically referred to the opportunities for tax planning offered by them in the Margo Commission Report paragraph 10.114. The Margo Commission recommended the amendment of the Income Tax Act especially with regard to the distribution in specie of trading stock. An amendment in this regard is contained in the 1990 Income Tax Act, in terms of which any company distributing any assets now must make such distributions at market value and if the asset comprised, for instance, trading stock, taxable income would arise. Similarly taxable recoupments on fixed assets may arise.

Advantage has been taken by many taxpayers to distribute in specie fixed property and share portfolio investments where in the hands of the company or close corporation holding such assets, it was not clear that a disposal of such assets would have been on capital account, or even where a disposal by the company holding such assets it was quite clear that a disposal would have attracted a liability to taxation. The writer has personally experienced situations where such assets held on revenue account and having market values significantly greater than their cost or book value, have been distributed in specie to shareholders who have then almost immediately realised such assets at substantially greater market values, without being subjected to taxation thereon, the sale value and the market value on acquisition being the same or similar amounts in the hands of the shareholder.

For valuing a company, or structuring a transaction the opportunities offered by the Income Tax Act, as above, must constantly be known to the valuer and negotiator of any transaction. A failure to do so could result in a transaction being structured in a far more tax expensive manner, causing either a purchaser or a seller suffering a cost in respect of unnecessary taxation.

Very often if is found that a merger or acquisition takes place with the acquiring company issuing its shares to the shareholders of the company being acquired, in exchange for their shares, or the consideration comprises such shares and cash or other assets. In such instances tax consequences to be taken into account are:

a) if any portion of the value of the shares issued are from the company's reserves and the shares become capitalisation shares

b) if the shares being disposed of and exchanged for new shares, etc, had been held as trading stock by the shareholders of the company being acquired, the provisions of Sections 22 and 24A of the Income Tax Act will become applicable.

Until the advent of the close corporation and the introduction of Sections 40A and 40B of the Income Tax Act, when valuing the issued shares in a company it was customary for a valuer to make an allowance in arriving at a value for such shares, if being sold or acquired by a natural person, of thirty-three and one-third percent of the accumulated revenue reserves upon which there was a contingent tax liability, payable if and when such reserves would be distributed by way of a dividend.

The introduction of Sections 40A and 40B of the Income Tax Act provide for the payment of a lower rate of tax and since their introduction it has become customary and accepted practice for a

deduction of 10% of any such revenue reserves to be allowed in making a valuation. (Since the promulgation of the 1990 Income Tax Act in terms of which dividend receipts are generally tax-free other than for two specialised categories of taxpayers, no such allowances are made in making valuations as there is no further contingent tax liability).

In terms of Section 40A, on conversion of a company to a close corporation in terms of the provisions of Section 27 of the Close Corporations Act 1984 (Act No.69 of 1984), a tax of ten percent of the undistributed revenue profits as at the end of the latest year of assessment of such company which ended immediately prior to the conversion, has become payable.

Section 40B on the other hand provides for a tax of ten percent of all revenue reserve distributions made in anticipation of the liquidation or deregistration of a company, or during its liquidation, where all the membership requirements necessary for the conversion of the company to a close corporation are present. Thus the tax payable in such event is even less than ten percent of the total reserves. This position may be illustrated as follows:

Total revenue reserves available for distribution	100,00
Less: Distributions to shareholders	90,09
Tax payable (10% of 90,09)	9,01

Distributions to shareholders, of any reserves which are not revenue reserves and where Sections 40A or 40B of the Income Tax Act have been applied, are distributed free of taxation in the hands of both the company and the shareholder.

Accordingly, the valuer must have a clear understanding of how and when the provisions of those sections may be applicable, and the effects of their application on any valuation.

Where the provisions of Sections 40A and/or 40B could not be applied, (e.g. there are far too many

shareholders), then I am of the opinion that a valuer would still be justified in making a maximum contingent tax allowance of thirty three and one-third of the revenue reserves of a company, in the event of the distribution thereof in lieu of the contingent liability of shareholders for taxation on dividend distributions from such reserves.

A further very important section of the Income Tax Act which any valuer must carefully consider, is the provisions of Section 8C, particularly where there is any intention to first sell the business assets of the company. This section provides for the taxation, in the hands of the selling shareholder, as a deemed dividend, the amount by which the consideration received on the disposal of a private company's shares exceeds the cost or market value, as the case may be, of those shares. This excess is however limited to the proportionate amount of the company's reserves, revenue and capital, which before the disposal of the shares, could have been distributed by the company as a dividend. In order for the above to be applicable, both of the following requirements must exist at the time of the share sale:

a) the company was not carrying on business, or if it was carrying on business, it had entered into an agreement for the disposal of its business assets, or it had cash, claims or other assets not directly employed in its business, excluding any claim or asset (other than a debt owed by any shareholder of the company), which the Commissioner is satisfied could not be disposed of or realised at the said time, and so much of any cash or the cash equivalent of any claims or assets, not so employed as the Commissioner is satisfied was required by the company to meet its obligations, and;

b) the Commissioner, having regard to the circumstances, is satisfied that the sole purpose or one of the principle purposes of the seller in disposing of his share or interest therein was to derive an amount or benefit substantially similar to the accrual to him of a dividend from the company.

It must be borne in mind that even where a single shareholder has sold his shares, and the remaining shareholders and company have done nothing more than to sell or agree to sell the business assets of the company, that single shareholder could find the provisions of the Section being applied to his sale of shares.

Furthermore, where any loan to the shareholder has been deemed to be a dividend received by the shareholder in terms of the provisions of Section 8B, the amount or value of such loan must, to the extent that it has not already been extinguished by the set-off of any dividends under that Section, be deducted from the amount of the profits and reserves which may be regarded as being available for distribution by the company.

The provisions of Sections 8B and 8C do not apply to members of a close corporation.

The emphasis in Section 8C appears to be on the retention by the company of excess or surplus assets which could have been distributed by the company by way of a distribution. Unfortunately, a minority shareholder not sufficiently influential to cause a company to make a distribution, is likely to find himself having to make a substantial allowance for the contingent tax liability which will arise when the revenue reserves are distributed, in order to sell his shares, is also likely to find that should the Commissioner decide to apply the provisions of Section 8C to the minority shareholder's sale of his shares, taxation will again have to be paid, not only on the revenue reserves but on all the reserves that could be apportioned to him. Furthermore, as any subsequent distribution by the company would be to the new shareholder, the distribution would be subjected to taxation a second time in his hands. There would be no relief from 'double taxation' as two separate taxpayers will have been involved.

Accordingly, minority shareholders must be extremely wary of situations which arise in terms of which

the business assets of the company are disposed of, and there is no agreement between the shareholders for the distribution of the company's assets to shareholders or even for the voluntary liquidation of the company. Failure to do so could result in such a taxpayer having to personally realise his investment, at a discount for the contingent tax liability and still bear the actual taxes if Section 8C were applied by the Commissioner.

Expenditure incurred by shareholders, particularly minority shareholders, in obtaining valuations and in protecting their rights and in opposing or even amending a merger or acquisition, is generally of a non-deductible nature. Such a shareholder would have a difficult task to prove that their expenditure in this regard, qualified in terms of Section 11(a) of the Income Tax Act:

- was incurred in the production of income, and
- was wholly and exclusively laid out for the purposes of trade, and
- was not of a capital nature.

Similarly, any legal expenses incurred would only be deductible in terms of Section 11(c) of the Income Tax Act if not of a capital nature.

As a result of the amendments contained in the 1990 Income Tax Act from 1 March 1990 dividends and deemed dividends, such as those arising out of Section 8C are no longer subject to normal tax in the hands of individuals. However, in the cases of persons who are not resident in the Republic and do not carry on business in the Republic the liability for Non-Residents' Shareholders' Tax at the rate of 15% on the dividend still remains. With this change in legislation the provisions of Sections 40A and 40B also were no longer of any relevance. However, there continues to be a great amount of speculation that legislation is likely to be promulgated at a future date which will reintroduce taxation on dividends and a knowledge of how the legislation has been applied in the past would be both informative and instructive to a valuer on such reintroduction.

TAX IMPLICATIONS ON THE ACQUIRER

The intention with which a purchaser acquires shares in a company is of importance and central to the ultimate tax consequences when those shares are finally disposed of.

The acquisition of a controlling interest in a company is normally of assistance in establishing a capital intention because control of a company is a normal means by which some other business purposes may be fulfilled, other than the ultimate disposal of such shares at a profit. However, the acquisition of control of a business and its assets, other than by way of a shareholding, may be difficult to prove to be with a capital intention due to the acquirer's own ability to trade with or dispose of such assets.

The manner in which the acquisition is financed, the period that the shares or assets are held, the purpose of the acquisiton, the ability or inability to fulfill the purpose and intentions of the acquirer and many more factors are all of significance ultimately, in determining whether a profit made on the disposal of the shares or assets is subject to taxation or, just as important, whether a loss realised is deductible. Very often everything is structured and claimed to have been done on capital account, even where there was an ultimate intention to sell at a profit, and when the sale does take place there is a resultant loss. Such a loss will in such circumstances not be deductible, having been on capital account. Where from the outset the transaction was shown to be on revenue account the losses sustained would most probably be deductible.

The subject of intention, mixed intentions and changes of intention is dealt with on pages 69 to 73.

Until the 1990 Amendment to the legislation with regard to dividends as referred to above and the

deletion of the legislation relating to Undistributed Profits Tax ("UPT"), a valuer had to carefully consider the effects of UPT in determining or considering the dividend policies of a group of companies. In particular, the position of a company acquiring shares in another company well endowed with reserves which may be distributed must be considered. UPT may become payable when a company in which a shareholding is acquired, causes to be declared out of pre-acquisition accumulated profits or reserves, a dividend. Irrespective of the accounting treatment by the company receiving the dividend, of the receipt thereof, a UPT liability may arise. It is correct accounting policy to treat dividends received out of pre-acquisition profits as not forming part of the recipient company's profits available for distribution, but rather as a part return of the investment made, thus reducing the cost value thereof. Accordingly, dividends received out of pre-acquisition profits do not generally form part of the profits available for distribution by the company in receipt of such dividends. The recipient company, unless itself well endowed with reserves available for distribution by way of dividends, will be unable to avoid any liability for UPT, by the distribution of dividends during the relative specified period. In effect, care must always be exercised where the acquirer of shares, acquires shares where the purchase consideration is, in the main, represented by reserves in the company in which the shares are acquired. It is interesting to note that if the acquiring company is itself wholly-owned and controlled by a close corporation throughout the specified period for UPT purposes, then the acquiring company would be exempt from UPT - (Section 50(i)(i) of the Income Tax Act).

Unless the acquisition was, from inception, made on revenue account, expenditure incurred by an acquirer in carrying out a merger or acquisition, will be of a capital nature and not deductible. A purpose or intention to improve one's income earning structure is of a capital nature, whereas an intention to acquire a share or asset in order to resell it, would normally be of a revenue nature. The subject of capital and revenue is specifically not dealt with in this document it being a vast and separate subject on its own.

The question of the deductibility or non-deductibility of interest paid in respect of the financing of an acquisition, is always of great significance and may affect the structuring of a transaction. Although this subject is dealt with in detail on pages 74 to 87, the effects may be briefly stated to be the deductibility of interest paid on finance borrowed to fund the acquisition of assets, is usually more assured than is the deductibility of interest on funds borrowed to acquire shares.

Like all other expenditure, interest must be incurred in the production of income and dividend receipts being either exempt or partly exempt from taxation, connected expenditure such as interest, will similarly be non-deductible or only partly deductible.

Section 11(a) of the Income Tax Act provides for the deduction of expenditure incurred in the production of income. Section 10(1)(k) of the Income Tax Act exempts from taxation dividends received by companies, resulting in such dividends not forming part of income as defined and, as a consequence, the interest expended by a company on funds borrowed to acquire shares for dividend purposes will not generally be deductible. The same principle applies to the extent that such income is free of taxation. With the introduction of the 1990 Income Tax Act, the same will apply to individuals in respect of dividends received and connected expenditure with effect from 1 March 1990.

Taxpayers contemplating the acquisition of shares, or for that matter any other assets which will not produce taxable income, should arrange their affairs in such a manner so as to ensure that all of their interest expenditure is deductible, or to minimise any disallowed portions of such expenditure. The onus is upon the taxpayer to ensure that he can clearly show that interest expenditure is deductible.

An avenue open to the taxpayer includes circumstances where the proceeds from an issue of shares to shareholders was used to finance the assets producing tax-free or tax-exempt income.

Alternatively, it should be shown that specific loans were raised for specific purposes, in the production of income, and that the assets producing the tax-free or tax-exempt income were financed out of funds generated from trading operations without incurring any interest costs. For example, funds received from sales or debtors could be placed into a separate banking account specifically set up for the purpose, in order to accumulate the necessary funds for the acquisition of the assets producing such tax-free or tax-exempt income, and those funds may thereafter be utilised for this purpose. The interest on any funds borrowed on overdraft or otherwise to provide working capital, in replacement of the funds withdrawn, should be tax deductible. Should no funds be available at the time to fund an acquisition of such assets, a specific separate loan account should be set up to finance the acquisition of those assets and all subsequent trading receipts such as sales and debtors collections, should be deposited to that specific loan account, in order to settle as soon as possible the specific loan, and so minimise the non-deductible interest expenditure. Interest incurred in the meantime on other financing such as on bank overdraft, should be deductible as those funds will have been utilised in the income producing operations of the taxpayer.

INTENTION

Before any valuer of any asset commences his valuation it is most important for him to establish the purpose and intentions with which the asset and possibly its component parts were acquired (e.g. a shareholding in a company as well as the underlying assets within the company). Without this knowledge, which is not always clearly ascertainable, the valuer embarking upon a valuation may well be doing so totally unequipped to carry out his mandate professionally in such a manner as to be able to warn his principals of lurking tax perils.

Our courts have laid down that one of the most important tests to be applied when deciding whether a receipt or accrual consists of the realised proceeds of an asset which has been disposed of, is the intention which existed when the asset was acquired.

All receipts and accruals are either of a capital or of a revenue nature. There is nothing that will not fall into one of these two categories when considering income. The case relating to deposits on containers of Pyott Ltd vs. CIR (1945) AD 128; 13 SATC 121 is a case in point.

I do not intend dealing in any detail with the subject of capital and revenue, a vast subject in itself, but will dwell on the subject very briefly.

Perhaps understandably, the Income Tax Act does not define the meaning of a "capital" receipt or accrual. Our courts however are frequently called upon to determine the taxability of income and in so doing, are obliged to consider on the facts of those particular cases, whether the income is of a capital nature or not. Each case depends upon its own facts - Elandsheuwel Farming (Edms) Bpk vs. SBI (1978) 1 SA 101 AD, 39 SATC 163 (at p.174), and ITC 1299 (1979) 42 SATC 45 (at

p.51). However, the analysis of cases with similar circumstances has enabled a body of rules to be gathered whereby taxpayers are able to judge the probabilities of the taxation of similar circumstances.

The question of the taxpayer's intention is one such guideline which must always be considered.

The meaning of the word "intention" is not concerned with:

> "that kind of subjective state of mind required for the purposes of the criminal law, but rather with the purpose for which the transaction was entered into."
> - (Botha, J A in SIR vs. Trust Bank of Africa Ltd (1975) (2) SA 652 AD 669H; 37 SATC 87 quoting from CIR vs. Paul (1956) 3 SA 335 AD 340; 2 SATC 1.

In CIR vs. Stott (1928) AD 252; 3 SATC 253, Wessels, J A, referring to a dictum that for the purpose of ascertaining whether profits made upon the sale of an asset are taxable, depends upon whether the article was acquired for the purpose of trade or not. At page 264 he proceeded to say, "It is sufficient to say that the intention is an important factor and unless some other factor intervenes to show that when the article was sold in pursuance of a scheme of profit-making, it is inconclusive in determining whether it is capital or gross income."

At page 259 of the same judgement the following citation from the case of Overseas Trust Corporation Ltd vs. CIR (1926) AD 444; 2 SATC 71 formulated the guiding principle as follows:

> "Where an asset is realised at a profit as a mere change of investment there is no difference in character between the amount of enhancement and the balance of the proceeds. But

where the profit is, in the words of an eminent Scottish Judge, 'a gain made by an operation of business in carrying out a scheme for profit-making, then it is revenue derived from capital productively employed and must be income'."

The sale of an asset may produce proceeds of either a capital or revenue nature according to the particular circumstances of the case so that, whereas a transaction carried out by one taxpayer may be of a capital nature, the same or similar transaction may be of a revenue nature in the hands of another taxpayer. The taxpayer's intention could be to invest and hold the asset as an income-producing vehicle, a source of income. Alternatively, the taxpayer's intention may be to speculate by making a profit from the sale of the asset, effectively using the asset as trading stock. Taxpayers have, unfortunately for them, lost their cases because of their failure to convince the court on a preponderance of probabilities that they had merely realised a capital investment.

It is accordingly of utmost importance for the valuer to establish:

"Whether what has been done in the process of acquisition and realisation amounts to the carrying on of a trade or business."

- ITC 612 (1945) 14 SATC 385.

Failure to do so by the valuer can result in the negligent overlooking of what could be substantial tax consequences following upon a transaction based upon the valuation.

In determining the position it must be pointed out that the length of time for which an asset has been held is not necessarily decisive in determining whether the proceeds arising from its realisation will be taxable.

- Reliance Land And Investment Co (Pty) Ltd vs. CIR (1946) WLD 171; 14 SATC 47, and ITC 1200 (1971) 36 SATC 34 (at p.39.).

It is not essential that the intention was present at the time of acquisition. The intention may only have emerged or became apparent shortly after acquisition and such intention may then be made to relate to the acquisition.

Lace Proprietary Mines Ltd vs. CIR (1938) AD 267; 9 SATC 349.

Should the taxpayer have had mixed intentions when acquiring the asset, the dominant intention operating to induce the taxpayer to effect the purchase will usually determine the issue.

In COT vs. Levy (1952) 2 SA 413 AD; 18 SATC 127, the taxpayer acquired shares as an investment, but he also hoped that the property owned by the company would be realised at a profit so that his shares would increase in value. No attempt was made to find a purchaser for the property and it was eventually sold only when an exceptionally favourable offer was received by him for his shares. The court held that the taxpayer's dominant purpose was to acquire the shares as an income-producing asset. The resultant profit from the sale of the shares was of a capital nature. The legislature could not have intended that the slightest contemplation of a profitable resale of a capital asset had to be disproven by the taxpayer.

In the case of African Life Investment Corporation (Pty) Ltd vs. SIR (1969) (4) SA 259 AD; 31 SATC 163 the court also considered the dominant purpose of the taxpayer in order to determine the taxability of amounts received.

A dominant purpose exists where the alternative objective, though perhaps in contemplation and even a material factor in the general decision to purchase, was entirely secondary and did not operate to any substantial extent on the taxpayer's mind. If the taxpayer's actual motives were so mixed that he could be said to have been substantially and almost equally moved by both motives, the preference of the one potential result as compared to the other would not amount to a dominant purpose.

In African Life Investment Corporation (Pty) Ltd vs. SIR (1969) (4) SA (259) AD; 31 SATC 163, Steyn, C J expressed the view, "Whether or not a purpose is dominant in the sense that another co-existing purpose may be effected at a profit without attracting liability for tax, is a matter of degree depending on the circumstances of the case. A purpose may be a main purpose without being dominant in this sense. I shall not attempt a precise definition of the distinction, but there would, I consider, be such a main purpose where there is a further purpose simultaneously pursued by way of an additional, albeit subsidiary, activity calculated and intended to yield a profit."

Accordingly, it follows that taxpayers are not required to exclude even the slightest contemplation of a profitable resale of an asset in order to claim that the asset was acquired on capital account.

The actions of the taxpayer sometimes are directly related to his alleged intention. In ITC 1343 (1981) 44 SATC 11, it appears that it was not enough merely to refer to the intention or alleged change of intention of the taxpayer.

The failure of the members of a syndicate to conclude a proper partnership agreement providing for the allegedly planned factory development on vacant land was taken into consideration against the taxpayer in Wilcox vs. CIR (1960) (4) SA 599 AD; 24 SATC 1 when the vacant land was sold.

In ITC 1142 (1970) 32 SATC 237 weight was given to the fact that the taxpayer was requested to lodge collateral security in the form of a life assurance policy for finances used to purchase the asset. His accountant had warned him that this cover would become redundant and was costly should he sell the property within a short period. The fact that he resisted the warning of his accountant because he had no intention of selling the asset was looked upon favourably by the court.

THE DEDUCTIBILITY OF INTEREST ON BORROWED FUNDS AND UNPRODUCTIVE INTEREST

Often when valuing a business, very little, if any, consideration is given by the valuer to the aspect of the financing of the acquisition, its attendant costs and the taxation consequences thereof. It is, however, not always the valuer's fault that this may occur as this aspect of many transactions is, probably one of the last aspects of any transaction to be given any attention and then it is most often done hurriedly without proper consideration of its consequences.

In my opinion it is of extreme importance for the valuer to be informed before he commences his valuation or at a very early stage thereof as to how the project is to be funded as the tax consequences thereof may result in a very different result to that otherwise contemplated. At the very least if such information is unavailable, the valuer should place a caveat upon his valuation so that suitable adjustments can in due course be made. Of course, the valuer for a seller would most likely not make any such adjustments as he would be entitled to presume that a purchaser will purchase for cash with no adverse resultant costs of financing such cash.

Accordingly, in this chapter I will attempt to highlight some of the circumstances which may give rise to interest paid, or a portion thereof, to be disallowed as a deduction and deemed to be unproductive interest.

Although all aspects of the finances raised may be of a regular nature in terms of any law and for accounting purposes may be treated in terms of all the normal and generally accepted accounting conventions, Revenue may contest the deductibility of interest in certain instances. Our courts have clearly confirmed that an amount in respect of interest paid, shown as an expense and deducted from

income, is not deductible for income tax purposes although correct otherwise. When considering the deductibility for tax purposes, all the other conventions must be set aside and only the principles and requirements of the law relating to income tax must be considered. Furthermore, it should be noted that there is no equity in tax law and although interest paid may be disallowed in the hands of the payer, it is most likely to be fully taxed in the hands of the recipient. Each such party stands alone and the effects of the treatment of such interest in the hands of the one party will have no effect whatsoever upon the other party.

The deductibility of interest in terms of the Income Tax Act is dealt with in terms of the general deduction formula (Section 11(a)), and certain negative provisions (Sections 23(f), 23(g) and 10(l)(k)(i)).

In ITC 1466 (1989) 52 SATC 25 (EC) in considering sections 11(a) and 23(g) of the Income Tax Act the court found that interest paid or credited on the loan account of the sole member of a close corporation, which loan arose as a result of the close corporation distributing undistributed or undrawn income, was not deductible for income tax purposes as it was found that the loan had not been employed in the production of income or for the purposes of the taxpayer's trade. The loan was as a result of a distribution of the close corporation's reserves and it was not raised for the purpose of producing income.

Sections 11(a) and 23(f) must be read in conjunction with one another.

Section 11(a) reads as follows:

> "11. For the purpose of determining the taxable income derived by any person from carrying on any trade within the Republic, there shall be allowed as deductions from the income of such person so derived.

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

Section 23(f) reads as follows:

"23. No deductions shall in any case be made in respect of the following matters, namely ...

f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in Section One;"

and in Section 1 of the Act, "income" is defined as:

"'income' means the amount remaining of the gross income of any person for any year or period of assessment after deducting therefrom any amounts exempt from normal tax under Part I of Chapter II."

Thus "income" is any "gross income" which is not specifically exempt from taxation.

Accordingly, it is quite clear from the understanding of the above-mentioned provisions of the Act that any interest paid or accrued in respect of funds borrowed in order to finance assets which are not capable of producing income, or only produce income exempt from taxation, the interest incurred, or such portion as may relate to such assets, may be non-deductible as an expense for income tax purposes.

Section 23(g) reads as follows:

"23. No deductions shall in any case be made in respect of the following matters, namely ...

g) any moneys claimed as a deduction from income derived from trade, which are not wholly or exclusively laid out or expended for the purposes of trade."

The provisions of Section 23(g) enforce the principle that expenditure, such as interest incurred on funds raised to finance assets which do not produce any income, or assets from which interest income is received at a lower rate than the rate paid, can be disallowed as a deduction. In this regard Revenue do look to the taxpayer's intention and the possibilities of the taxpayer receiving income. In the case where interest is received at a lower rate that the interest rate paid on the borrowings, it is usually found that only the shortfall in the interest received is disallowed, effectively bringing the transaction to a break-even situation. Thus the interest paid is limited to the interest received.

Included among the exemptions is Section 10 (l)(k)(i) which reads as follows:

"10(l) There shall be exempt from tax ...:

(k)(i) dividends received by or accrued to or in favour of any company; provided that this exemption shall not apply ...

(ee) to dividends received by or accrued to any company which during any portion of the year of assessment is a close corporation."

Accordingly, dividends received by a company which is not a close corporation are not subject to income tax. Interest incurred on funds raised to finance share purchases, where the dividends are not subject to taxation, is therefore not a deductible amount.

Until 1 March 1990 dividends received by close corporations were not exempt from taxation but subject to a deduction of one-third of the gross dividends received. Individuals were similarly subject to taxation on dividends received subject to a deduction of between thirty-three-and-one-third and one hundred percent of the gross dividends received.

With effect from 1 March 1990 the above position has been amended in terms of the 1990 Income Tax Amendment Act promulgated on 11 July 1990. The relevant wording of Section 10(l)(k)(i) has been amended to read as follows:

> "10(l) There shall be exempt from tax ...:
>
> (k)(i) dividends received by or accrued to or in favour of any person; provided that this section shall not apply ..."

It will be observed that all companies, close corporations and individuals are, since 1 March 1990, exempt from income taxation on dividends and accordingly any interest now incurred since 1 March 1990 by such taxpayers in respect of shares acquired at any time will not qualify for deduction.

Where such interest was previously deductible either in whole or according to the taxability of the gross income from dividends receivable, such taxpayers no longer enjoy the deductibility of such interest payments. Although the dividend income is now tax-free, investors would be wise to examine the structuring of their borrowings so as to attempt to ensure that interest payments are not classified as being "unproductive" for income tax purposes. Where possible such loans should be repaid and fresh finance raised for income-producing purposes. The finances invested in shares should, if possible, bear no interest in order to maximise after tax net returns.

The courts have in many instances had to consider the question of deductibility of interest. It is quite clear that interest paid on funds borrowed to finance shares is presumed, until the contrary is proven, to be interest incurred not in the production of income.

The burden of proof that an expense such as interest is deductible always rests with the taxpayer in terms of Section 82 of the Act. The taxpayer must therefore ensure that he can clearly show that borrowings which bear interest, were applied to his income-earning activities, even if no actual net income may have been derived during the year of assessment. There are a number of judgements relating to the deductibility of interest arising from the financing of shares which have been in favour of the taxpayer.

Some of the more common circumstances giving rise to the disallowance of interest deductions are:

a) loans to purchase dividend-yielding shares;

b) loans to fund tax payments;

c) loans to fund the acquisition of foreign assets which will produce income from a source not within or deemed to be within the Republic;

d) loans to fund dividends declared by companies;

e) loans to fund distributions to members of close corporations;

f) loans raised to fund new loans or investments which are not expected to result in the receipt of net income;

g) interest or penalties paid to the Receiver of Revenue on underpayments or late payments of provisional taxes, assessed taxes, PAYE or sales tax - Section 23(d).

Particular attention must always be given to the capital and loan structures of any company or close corporation being valued. Where any part of the loan capital due to shareholders or members, or for that matter others as a result of payments already made to shareholders or members, arises as a result of dividends distributed or income awarded to members of close corporations, the interest on such loans payable relate specifically to the financing of such distributions of profits which were already earned and not in the production of income. Similarly, care has to be exercised where in contemplation of a sale, or for some other reason, a company or close corporation revalues its assets

and distributes such surplus as may arise on the revaluation to its shareholders. A change in shareholders takes place. If the new shareholder, wittingly or unwittingly causes the company to pay interest on the resultant loan account, such interest will not be deductible for tax purposes in the company, and the shareholder or loan creditor will pay normal income tax on the interest received. - See ITC 1466 (1989) 52 SATC 25 (EC) referred to on page 75 of this document. The revaluation of the property and the interest paid will not have given rise to any additional income or income-earning ability in the company. Accordingly, any experienced valuer seeing large loans or revaluations of assets should investigate how they arose and their tax status. In many of the instances where companies have been converted to close corporations, surpluses arising on the revaluation of the assets at the time of conversion have been distributed to members. Interest on such loans is not deductible. It is suggested that, where such credit loans do exist, shareholders or members should make all their drawings against such loans first in order to reduce such loans as speedily as possible. Any new funds advanced by them, e.g. remuneration credits, etc, should be credited to a separate loan account so as to clearly identify the different categories of loan accounts. The separate loan account could bear interest which would be a deductible expense.

With regard to a shareholder wishing to acquire an interest in a property-owning company and such share investment has to be funded from borrowed interest-bearing funds, the disallowance of interest can be totally avoided by the purchaser requesting the seller, at the purchaser's cost usually, to convert the company from a conventional company or close corporation to a "share block" company. The purchaser would then purchase shares in a share block company, such shares carrying a right of use. This right of use would entitle the purchaser to derive rental income which would be the reason for the purchaser's acquiring the shares. Accordingly, any interest paid on funds borrowed to purchase such shares would be tax-deductible in the hands of the shareholder. Furthermore, any interest payable by the share block company on a mortgage loan over the property owned by the company would be recovered in the monthly maintenance levies payable by the shareholders. Such levies also rank for a deduction against the rental income in the hands of the shareholder.

There is no specific fixed basis upon which calculations of unproductive interest must be made. However, the criteria to be applied is that of fair and reasonableness. It has been found that generally, as income may fluctuate from period to period, such fluctuations being unconnected to the interest paid, the allocation of interest paid, in the ratio of income received does not meet the above-mentioned criteria. Our courts have found that what is now known as the "assets basis" is generally an acceptable fair and reasonable basis of computation of unproductive or disallowable interest paid. Under the "assets basis", interest paid on funds not applied to the financing of specific assets is multiplied by the ratio of unproductive assets to total assets. Income in the form of interest received and derived from such financing is deducted from the unproductive interest. Of course, unproductive interest specifically identified as relating to a specific unproductive activity does not require such apportionment as it can be specifically identified and allocated to its specific application. The amount of the finance and the value of the assets so specifically financed, are excluded from the "assets basis" formula referred to above.

Furthermore it must be borne in mind that if there was a genuine intention to derive taxable net income, even though such net income was not achieved during the tax period under review, interest paid has been allowed as a deduction.

The courts tend to consider the following factors when deciding a case relating to the deductibility of interest paid:

a) The purpose for which the funds upon which the interest paid was borrowed.

b) How the funds were actually used or applied is not necessarily a decisive factor, although an important consideration.

c) Whether there has been any change in the purpose and the application of the funds since borrowed. if such a change were found to exist whereby the funds are now applied to unproductive assets, the interest paid could be disallowed.

d) The closeness or relationship of the link or connection between the interest paid and the income-producing activities, if any. Where shares are financed and the investments produce expected income other than dividends, the courts have looked at how closely connected the interest is to such income and whether or not some other act or intervening circumstance caused the earning of such income.

In the case of Producer vs. COT (1948) SR 62, 15 SATC 405, the taxpayer formed a South-African subsidiary company in order to increase the market for its product. The South African company owed a substantial sum which had arisen in the ordinary course of business, to its holding company. The debt was converted into shares and the Commissioner of Taxes sought to disallow unproductive interest claimed by applying the "assets basis" computation to the total interest paid. The court held that the disallowed interest was allowable as the original debt had arisen in the ordinary course of business and that there was no connection between the borrowing and the purchase of the shares.

In this case the court laid down two important principles, these being:

1. Where a taxpayer borrows a specific sum of money and applies it to a purpose unproductive of income, and not directly connected with the income-earning part of his business, then the interest paid on such borrowings cannot be deducted as expenditure incurred in the production of income; and
2. Where a taxpayer for good and sufficient reasons borrows money for use in the business producing his income, despite the fact that he may subsequently, in pursuit of a legitimate

business purpose, apply or invest such funds in an investment which does not produce taxable income, the interest remains deductible for income tax purposes.

In another Rhodesian case, Financier vs. COT (1950) SR 69; 17 SATC 34, the taxpayer carried on the business of moneylending, and also made investments in shares in various companies. The company borrowed interest-bearing funds used for the general purpose of its business. The Commissioner of Taxes disallowed a portion of the interest paid considering it to relate to the financing of certain investments which produced no income. The court found that as the funds borrowed for investment purposes were both productive and non-productive of income, and, since it was not possible to distinguish for what purpose the money had been specifically borrowed, the taxpayer had failed to discharge the onus placed upon him, and a portion of the interest paid was not deductible.

It is on the basis of the above decision that many disallowances of unproductive interest paid is made, particularly in investment and holding companies.

In ITC 572 (1944) 13 SATC 461, the taxpayer had many years earlier borrowed money by way of debentures to finance business assets from which taxable income was received. The court held that the interest paid on that portion of the funds borrowed and used to finance interest-free loans to shareholders remained deductible as the purpose of the borrowing was to finance the ordinary business assets.

In ITC 574 (1944) 13 SATC 468, the taxpayer had borrowed funds from its shareholders and directors on which interest at 6% per annum was payable. These funds were used by the taxpayer as a portion of its ordinary business capital. During the year of assessment, the taxpayer held building society deposits upon which it earned interest at 4% per annum. The Commissioner for

Inland Revenue disallowed that portion of the interest paid which he considered represented a loss due to the investment yielding a lower interest rate. The court held that as there was no connection between the funds borrowed and the funds invested with the building society, no portion of the interest was disallowable.

In the case of CIR vs. Allied Building Society (1964) (4) SA 1 (AD); 25 SATC 343, the taxpayer carried on the business of a building society which required it to borrow interest-bearing funds from the public and place them at higher interest rates. Notwithstanding that a portion of the building society's funds were used to acquire non-productive properties (e.g. vacant land and properties under construction), which properties were intended to accommodate branches of the building society, all interest payable on borrowed funds was found to be deductible. The acquisition of the unproductive properties was merely incidental to the society's business of borrowing money in order to earn income by investment. Similarly, if the society chose to allow some of the borrowed funds to lie idle, or earn a lower rate of interest than that payable, such action would not provide grounds for any reduction in the allowable expense for interest paid.

The courts held that the circumstances in the case of CIR vs. Standard Bank of SA Ltd 1985 (4) SA 485 (A), 47 SATC 179 were similar to those in the above-mentioned case of CIR vs. Allied Building Society. Given the facts that the Standard Bank, as a matter of policy, accepted all deposits offered by its clients, its reluctance to enter into a financing transaction by way of preference shares and the number of, amount and frequency of the transactions in relation to its other business, the total interest paid was held to be deductible.

In the 1928 case of CIR vs. Shapiro (1928) NPD 436; 4 SATC 29, the taxpayer purchased shares in a company conditional upon his appointment as managing director of the company. In addition to dividends on the shares, the taxpayer received remuneration comprising a salary, housing allowance

and a commission. The court was asked to determine whether the interest paid was to be deductible from remuneration income or from the dividend income. The court found that the purpose of the borrowing of the funds by the taxpayer was to acquire the shares, the remuneration being earned by the taxpayer's own energy and ability and not from the borrowing. Accordingly, the interest paid was not deductible from the remuneration income.

In contrast to Shapiro's case is the case of ITC 1428 (1985) 50 SATC 34 where the taxpayer was employed by an incorporated firm of engineers. On being promoted to a new position with the same rights as a director, his service agreement required that he hold shares in the company in order to occupy that position. The taxpayer borrowed funds on overdraft in order to finance the qualification shares. The court found that the taxpayer was required to hold the shares in order to improve his position and, as a result of the new position, he had earned additional remuneration. The share acquisition was found to be essential to the acquisition of the additional remuneration. Accordingly, the court held that the interest payment was sufficiently closely linked to the income-earning capacity of the taxpayer to justify its deduction.

A leading judgement on the subject of unproductive interest is that delivered in the well-known case of CIR vs. Drakensburg Gardens Hotel (Pty) Ltd (1960) (2) SA 475 (AD); 23 SATC 251, upon which many subsequent cases have relied or in respect of which the courts have distinguished the facts. In this case the taxpayer leased certain farm property on which hotel premises and a store were located. The taxpayer derived rental income from the hotel and trading profits from the store. In order to obtain absolute control, the taxpayer purchased the shares in the lessor company so that it could avoid payment of transfer duty. The result of the transaction was to ensure security of tenure and a continuance of income. The Commissioner sought to disallow the interest paid on the funds which financed the share acquisition. The taxpayer argued that the purpose of acquiring the shares was to acquire absolute control of the hotel and store premises, thereby ensuring itself the

security of tenure and the rights to effect improvements as desired and to sub-let at an increased rental without requiring consent from third parties and without having to pay an increased rental. Considering the above the court held that the purchase of the shares was not for the purpose of securing dividends but to secure control of a revenue-producing asset. The payment of interest and the production of the income were sufficiently close to warrant the deduction of the interest.

Two special court cases, ITC 1144 (1970) 32 SATC 272 and ITC 1356 (1981) 44 SATC 139 dealt with the deductibility of interest paid on funds used to acquire shares where management or administration fees are receivable. Both of these cases relied on the decision in the Drakensburg Gardens Hotel case, and in both instances the interest was disallowed as being unproductive interest, the taxpayers being unable to show that at the time of acquiring the shares they did not also have as a motive the earning of dividends as well as interest, management and administration fees.

With regard to interest payments, valuers and taxpayers should also ensure that the rate of interest payable is fair and reasonable and at arms' length, particularly where connected or associated persons are involved (e.g. interest on shareholders' or directors' loans).

Where excessive or unreasonable interest rates are applied, Revenue may challenge the deduction of such interest on the grounds that it was not wholly and exclusively laid out or expended in the course of trade - Section 23(g). Although there are no laid down or specific means of determining excessive interest, it is considered wise to ensure that interest rates paid in such circumstances are not greatly in excess of that paid from time to time by the financial institutions, but also taking into consideration risk and security held.

Furthermore, especially when interest payments take place between companies or other entities within a group, the liability to pay the interest must be legally present and the liability must, as at tax year end, be unconditional and not contingent upon subsequent events or decisions.

It can thus be seen that the non-deductibility of interest on funds raised to fund an investment or within a group of entities can have a profound effect upon the after-tax income that will be generated. The lower this after-tax income, the lower the value that a valuer will place upon the investment or assets being valued. Sound planning at an early stage has often been found to be a key factor in reducing, if not removing, in full the non-deductibility of unproductive interest.

RECOUPMENTS

Recoupments in respect of fixed assets, generally constitute the amounts by which the selling price of an asset exceeds the income tax written-down value, limited, however, to the total of the deductions allowed for:

a) any initial allowances under Section 12;

b) wear and tear under Section 11(e);

c) annual allowances under Section 13; and

d) obsolescence under Section 11(o).

More specifically, in terms of Section 8(4), all recoveries or recoupments of amounts deducted or set-off under the provisions of Sections 11 to 20 inclusive, other than:

a) recoveries of contributions to any pension fund under Section 11(k);

b) expenditure incurred for the purpose of scientific research for the development of his business if such expenditure is not of a capital nature under Section 11(p);

c) capital expenditure on scientific research under Section 11(q);

d) allowances for expenditure on housing for employees of manufacturers in economic development areas under Section 11 quin;

e) machinery investment allowances under Section 12(2) or Section 12(2) as applied by Section 12(3);

f) hotel equipment investment allowances under Section 12A(3);

g) building investment allowances under Section 13(5) or Section 13(5) as applied by Section 13(8);

h) under Section 13 bis (7);

i) under Section 15(a);

j) any beneficiation allowances under Section 15A.

In Winter and Others (Executors of Sir Arthur Munro Sutherland (deceased)) vs. IRC - (1961) 3 ALL ER 855, shares were to be valued in terms of the relevant legislation, by reference to the net value of the assets of the company. The company's assets included ships in respect of which substantial depreciation allowances had been allowed for income tax purposes. The valuation of the ships at their then market value would give rise to a substantial recoupment of the previously allowed depreciation allowances, and the question for consideration by the court was whether taxation on those recoupments should be taken into account in valuing the company's net assets. The House of Lords decided that such taxation should be taken into account.

In Moorreesburg Produce Co Ltd vs. CIR (CPD 1945) 13 SATC 245, it was found that an amount recovered under an insurance policy in respect of machinery destroyed by fire gave rise to a partial recoupment of deductions previously allowed for wear and tear, notwithstanding a contention rejected

by the court that the appellant company could not be said to have recouped or recovered any such deductions as the proceeds of the insurance claim did not exceed the current replacement value of the assets destroyed.

With regard to crockery, linen, loose tools and similar items, these items are usually regarded as being of a consumable nature and allowances are made for their scrapping and replacement measured by replacements. This allowance is made based on the difference between the value at the beginning of the year, plus any purchases during the year, and the value of the asset at the end of year. Accordingly, any amounts received on disposal, in excess of such year end or closing value, are recoupments which are taxable in terms of Section 8(4).

Recoveries or recoupments of lease premiums deducted in terms of Sections 11(f) and (g), to the extent of the difference between the income tax written-down value thereof and their selling price, are recoupments which are taxable in terms of Section 8(4), subject to such difference not exceeding the value of the deductions allowed off the original cost of such lease premiums.

Recoveries of any debts previously written off as bad debts and allowed as a deduction under Section 11(f) constitute taxable recoupments under Section 8(4). However, amounts included in the doubtful debts allowance in terms of the provisions of Section 11(j), when recovered, do not constitute taxable recoupments as the provisions of Section 11(j) are self-contained and the automatic add-back of the previous year's allowance takes care of the situation in that the amount is written off as a bad debt and the debt, having been recovered, is excluded from any new doubtful debts allowance.

It is furthermore interesting to note that in terms of paragraph (n) of the definition of "gross income" in Section 1 of the Act, all amounts received or accrued in terms of Section 8(4), are

deemed to have arisen from a source within the Republic, notwithstanding that any such amounts may have been recovered or recouped outside of the Republic.

In ITC 681 (1949) 16 SATC 357 the amount reflected as the consideration for machinery and plant sold in terms of an agreement for the sale of the taxpayer's business to a private company, was considerably in excess of the written-down tax value of the assets and this excess was subject to taxation in terms of Section 8(4), this being a recoupment. The court dismissed the taxpayer's appeal on the evidence and rejected a contention that the amount allocated to machinery and plant did not represent the actual selling price thereof but included goodwill. In the absence of any stipulation in the agreement as to the amount that was to be paid for goodwill, no amount could be attributed to goodwill. This was clearly a case of the taxpayer having entered into an agreement without obtaining tax advice. Two further relevant cases which also illustrate that it is immaterial whether the amount in question is an accrual of a capital nature or not, and that in respect of all deductions previously allowed, the recoupment provisions of the Act calls for the inclusion of the full amount recovered or recouped in the year of assessment in which such recovery or recoupment takes place are ITC 559 (1944) 13 SATC 306 and, ITC 565 (1944) 13 SATC 330.

Plant and machinery destroyed by water or fire give rise to special treatment of any recoupments arising therefrom. The recoupment of wear and tear allowances and initial allowances previously granted in respect of the plant and machinery used directly in a process of manufacture or in a process similar to a process of manufacture, is not included in the taxpayer's income, if the recoupment arises as a result of the damage or destruction of the asset by water or fire, provided:

a) the taxpayer concluded, or will conclude within a period of one year, or such longer period as the Commissioner in the circumstances may allow, from the date of the damage or destruction ("the event"), a contract for the acquisition of new or unused machinery or plant to replace that which was damaged or destroyed, and

b) the new or unused machinery or plant has been or will be brought into use within three years from the date of the event, and

c) will be used by him directly in a process of manufacture or any other similar process for a period of not less than five years or until the machinery or plant is scrapped or disposed of in the ordinary course of the taxpayer's trade prior to the expiry of such period of five years.

Any recoupment which has not been taxed in terms of the above circumstances, must be deducted from the cost of the new or unused machinery and plant acquired to replace the damaged or destroyed assets, for the purposes of determining wear and tear, initial and scrapping allowances. However, it must be noted that during such periods that the investment allowance was available, such allowance was to be calculated on the full cost without any reduction for the recoupments.

Should the taxpayer in any subsequent year of assessment cease to comply with any of the three conditions set out in (a) to (c) above, the untaxed recoupment must be included in the taxpayer's taxable income for that year of assessment. In such event, however, the value of the new machinery and plant, which would have been reduced in value for determining wear and tear, initial and scrapping allowances, must be increased by the amount of the recoupment now included in the taxpayer's income.

Furthermore, if the taxpayer at any time disposes of the new machinery or plant, for an amount in excess of the cost thereof less the amount of the untaxed recoupment in respect of the damaged or destroyed machinery, so much of such excess as does not exceed the untaxed recoupments in respect of the destroyed machinery must be taxed in addition to any other recoupments in respect of such machinery.

With regard to the third condition required for the recoupment not to be taxed, it is important to note that only a scrapping or disposal in the ordinary course of business qualifies. A scrapping or disposal due to a cessation of business within the required five-year period will result in the taxation of the previously untaxed recoupment and as the scrapping or disposal would no longer be in the ordinary course of business, the loss on scrapping, if any, would not be deductible being of a capital nature.

Similar special provisions relating to recoupments arising from ships and aircraft are also dealt with in Section 8(4). It is, however, not my intention to deal with these specialist areas in detail.

It is not uncommon to find that taxpayers who own industrial buildings in respect of which the 5% annual allowance is deductible for tax purposes, neither write off such allowance in their books nor provide for deferred taxation. Their reasoning is usually that the property does not or is not expected to diminish in value and that as they have no intention, at least in the foreseeable future, accepted as being more than three years for accounting purposes, no taxation is expected to arise.

Furthermore, where the profits after tax are attributable to non-residents, the decision not to write off the 5% annual allowance in the books of account, causes a greater after-tax book profit to be shown, thus facilitating increased remittances of income to such non-residents. However, an unsuspecting purchaser of the company or close corporation which houses such property which has been written down for tax purposes over many years, must enquire into and take into account any such annual allowances and the deferred tax consequences thereof. A failure to do so could result in the purchaser at some later date having to foot a substantial tax bill in the company or close corporation on a recoupment of the annual allowances if and when the property is sold out of the company or close corporation. (Note that until December 1989 the annual allowance was 2% per annum, and was increased to 5% per annum for all buildings, the erection of which commenced on or after 1 January 1990).

A taxpayer may elect that a recoupment of the annual allowances, on the sale or disposal of industrial premises, should not be subject to taxation in the year of its receipt, if he purchases or erects any other building which itself qualifies for the annual allowance. The taxpayer must make to purchase or commence erection within twelve months of the sale of the former property, or within such further period as the Commissioner for Inland Revenue may allow. In such case the recoupment is then set-off against the cost to the taxpayer of the replacement building purchased or erected by him. On making such an election, the 5% annual allowance is then granted to the taxpayer on the cost of the replacement building less the amount of the recoupment (Section 13(3)).

In valuing a company owning industrial property in respect of which the annual allowance has been deductible, the valuer must, in the writer's opinion, consider the tax effects of any recoupment and make a suitable adjustment in respect thereof. Usually, any such adjustment is heavily discounted due to the intention not to deal with the property itself in the foreseeable future.

Section 8(5) introduces a recoupment provision which, in certain circumstances applies to the purchaser of property whether movable or immovable. This section deals with persons who acquire property for a price in the determination of which allowance is made for the deduction of any rent or the equivalent of rent for the right of use or occupation of the property which that person or any other person may have paid and been allowed as a deduction in the determination of his taxable income.

The amount by which the purchase price is reduced will, in terms of Section 8(5)(a) be included in the income of the purchaser in the year of assessment during which he exercises his option to purchase or conclude the agreement of purchase.

In terms of Section 8(5)(b), where the deduction for rent payments is not specifically mentioned but

the property is acquired for a consideration which in the opinion of the Commissioner is not an adequate consideration, then the Commissioner, having regard to the circumstances, may include in the purchaser's income the amount of rent actually paid subject to a maximum of the difference between the fair market value of the property and the purchase price for which it has been acquired. The decision of the Commissioner is a discretionary power which is subject to objection and appeal.

It should be noted that Section 8(5) takes into account the rent paid by "any" person and not necessarily the lessee or ultimate purchaser. This is presumably to guard against the possibility that the taxpayer who claimed the deduction for the rent paid while occupying or using the premises might not himself purchase the property but might sell or donate his option to purchase at the reduced purchase price. Without the safeguard it would have been a relatively simple matter to circumvent the law.

As can be seen from the above, the valuer of any asset must be fully aware of the possibilities of a recoupment of a previously allowed deduction and that taxation that may arise therefrom. Furthermore he must be aware of the recoupments that may arise from what may appear to be simple capital transactions which would otherwise be free of taxation.

DONATIONS TAX

The reason for the existence of donations tax was described as follows by Boshoff, A.J.P. in Ogus vs. SIR (1978) 40 SATC 100, (3) SA 67 (T), (at 74):

> "At the outset it is necessary to draw attention to the fact that the donations tax was introduced to make up for loss of revenue by way of income tax and estate duty when certain types of donations are made. The mischief aimed at was the practice by taxpayers of reducing their assets by making donations and thereby reducing their income on which income tax is payable, reducing their assets on which estate duty would be payable at their death, and spreading the assets and the income derived therefrom over several taxpayers. The tax is consequently in terms levied in respect of the gratuitous disposal of property."

INTEREST-FREE LOANS AND DONATIONS TAX

Perennial questions are raised in regard to donations tax and other taxes as well as in regard to the implications of a loan which either bears no interest or interest at a low interest rate.

The question is often raised whether a loan which does not bear interest can attract donations tax in the sense that the absence of interest from the borrower to the lender constitutes a donation.

In CIR vs. Berold (1962) (3) SA 748 (A), 24 SATC 729, the appeal court regarded an interest-free loan as a continuing donation of the interest in the context of Section 7(3) of the Income Tax Act, where donation bears the meaning of a common law donation.

In the donations tax context, where the concept of 'donation' as defined in Section 55(1) is even wider, it seems clear than an interest-free loan can be regarded as constituting a continuing donation of the interest and that even low interest loans may be taxed on the basis of Section 5B as disposals of property inadequate consideration.

It is thus clear that both interest-free and low interest loans are potentially taxable for donations tax. Accordingly, the value attaching to the interest benefit passing from the lender to the borrower must be borne in mind in any estate planning or income tax planning. That interest factor would be subject to both income tax and donations tax.

Once it has been established that there has been a disposal of property under a donation by a donor, the property concerned must be valued to enable the taxable value of the donation and consequently the liability for donations tax to be calculated.

Where the donation is of money itself, the face value of the money will suffice to determine the value of the donation, but property other than money must be valued in order to ascertain its value - Ogus vs. SIR (1978) (3) SA67 (T), 40 SATC 100.

In ITC 1448 (1988) 51 SATC 58 (C) spouses had a joint will which provided for the massing of their estates, the survivor having a usufruct over the joint estate. Invoking Section 58 of the Income Tax Act the Comissioner levied donations tax on the difference between the value of the survivors estate and the usufruct thereover. The taxpayer succeeded in showing that the usufruct over the joint estate had a greater value than the assets disposed of by the survivor and so he won his appeal. In ITC 1387 (1984) 46 SATC 121 (T) the reverse situation occurred, the survivors assets contributed to the joint estate being of a greater value than the rights acquired.

Section 62 of the Income Tax Act prescribes a special method of valuation to be used to value each of three categories of property viz:

i) any fiduciary, usufructory or other like interests in property - Section 62(1)(a);

ii) any right to an annuity - Section 62(1)(b)

iii) the right of ownership of any property which is subject to a usufructory or other like interest - Section 62(1)(c).

In addition, that section also creates a general rule applicable to the valuation of any property other than that specifically mentioned.

This general rule is that the value of property for donations tax purposes is the 'fair market' thereof as at the date upon which the donation takes effect - Section 62(1)(d).

The general rule is, however, subject to three qualifications of which two permit the secretary to adjust the amount given as the fair market value to an amount he considers more appropriate and the third creates a special optional valuation procedure for immovable property on which 'bona fide' farming operations are carried on.

The first of these qualifications is that where certain conditions have been imposed by or at the instance of the donor which, in the opinion of the Secretary, results in the reduction of the value of the property in consequence of the donation, that property must be valued as if those conditions had not been imposed - Section 62(1)(d) (proviso). However, in terms of the decision in Ogus vs. SIR (1978) (3) SA 67(T) (at page 74), 40 SATC 100 it was found that where the founder of a trust donates cash to a trustee, subject to the condition that the trust shall be liable for the payment of

the donations tax thereon, that condition is regarded as one which does reduce the value of the donation received and not as a condition which reduces the value of the property, and that Section 62(1)(d) does not apply. Accordingly, the donor should consider reducing his donation and accepting the personal liability for the donations tax (if any).

The second qualification is that where the amount shown in any return as the fair market value is, in the opinion of the Secretary, less than the fair market value of the property, he may fix the fair market value of that property for donations tax purposes - Section 62(4).

Section 62(5) however, directs the Secretary to have regard to the following factors in so fixing the fair market value of the property:

i) the municipal or divisional council valuation (if any) of the property;
ii) any sworn valuation of the property furnished by or on behalf of the donor or the donee; and
iii) any valuation of the property made by any competent and disinterested person appointed by the Secretary himself.

In both these instances the exercise of the Secretary's discretion is subject to objection and appeal in terms of Section 63 of the Act.

In the case of the third qualification, where immovable property on which bona fide farming operations are carried on is to be valued, the definition of 'fair market value' in Section 55 creates an option for the donor to elect whether the property should be valued at its fair market value or according to the so-called Land Bank Valuation procedure set out in Section 55(2).

CONCLUSION

The aforegoing brief overview of some of the more important aspects of taxation supported by the case law considered does, in my opinion, identify aspects of taxation to be one of the many areas of knowledge required by an expert valuer in order to carry out his or her function in a responsible, efficient and professional manner.

Unfortunately, I have over the years witnessed a great many instances of valuations, opinions and computations having been issued without any reference to taxation. In most such instances there has not even been a note to the effect that the effects, if any, of taxation have not been considered nor taken into account.

The mere process of thinking taxation and its effects when carrying out the functions of a valuer will, in my opinion, in most instances, lead to a much more considered, professional and realistic valuation opinion. Without an up-to-date knowledge and consideration of at least the more major basics of taxation, I am of the opinion that any valuation opinion issued may be misleading and lead to gross over-valuation.

International as well as South African courts have from time to time had to apply their minds to those taxation aspects which could have influenced a valuation.

What about all those instances which never become subject to litigation in our courts?

I am firmly of the opinion that a valuer should be required not only to have the knowledge of taxation, but to set out in his or her valuation those aspects which have been considered, including

those which have been considered but which do not require any adjustments and the reasons therefore. The community, commercial and otherwise, very often places substantial value upon opinions of valuation as issued by valuers and they are entitled to receive responsible, properly considered and professionally prepared opinions.

COMPENDIUM OF TAX MATTERS AND TAX CASES OF INTEREST TO THE VALUER

Having dealt with some of the major areas of South African Income Taxation and their effects upon valuations, it is evident that without a thorough and up-to-date knowledge of South African Income Tax no valuer can adequately do justice to any business or company valuation.

To simply disregard taxation and its finer points could well result in the valuer grossly overvaluing the subject matter of his valuation.

To further assist the valuer with his most intricate and difficult task, I have set out in the following pages a compendium of some selected tax matters and tax cases which may be of interest to the valuer. This compendium has been arranged in alphabetical order of the subjects dealt with. A complete list of these subjects appears in the index to the contents at the beginning of this document and on the pages that follow.

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ADVANCE PAYMENTS - DEDUCTIBILITY

In ITC 703 (1950) 17 SATC 208 the appellant company erected a new factory, installed the necessary plant and commenced production during the year of assessment. In terms of an agreement entered into with a firm of technical consultants, the company paid to the consultants R25 000,00, satisfied by the issue of fully paid-up shares in itself, as consideration for services rendered during the year of assessment in supervising the factory's erection and the installation of the plant, and an undertaking by the consultants to continue for a total period of ten years to render technical and advisory services.

The company sought to deduct a proportion of the R25 000,00 in the year of assessment on a pro-rata allocation basis over the period of ten years. It was held that the payment for the services in connection with the erection and establishment of the factory as an income earning entity was of a capital nature and not deductible, but that so much as could properly be allocated to services connected with the ongoing working of the factory was deductible and that it was reasonable that an allocation should be made on the basis indicated over the period of ten years.

A question, however, must be asked as to whether any amounts are deductible in the second to tenth years of assessment as the expense accrued and was paid in the first year of assessment, and no further accrual or payment took place.

See page 109 for ITC 702 (1950) 17 SATC 206 which relates to the recipient of the shares in the above-mentioned case.

The expense, having been incurred and paid in full in the first year of assessment should have qualified the full deductible expense for deduction in that year of assessment.

The Income Tax Act does not require expenditure to be matched with income as one would attempt to do in times of accounting conventions. All that is required in terms of Section 11(a) of the Income Tax Act is that expenditure and losses be actually incurred, in the Republic, in the production of income from the carrying on of any trade.

Accordingly, in my view, in carrying out any valuation of any business or company, specific consideration is required with regard to prepaid or advance payments, as although they may provide for a cash flow saving in respect of such expense in future years, the annual pro rata diminution in value of such advance payments may not provide a deduction for income tax purposes.

The structuring of a suitable agreement which provides for an actual accrual or payment against the company would thus be desirable to ensure the deductibility of the value thereof.

ADVANCE RECEIPTS

Amounts received in advance for services still to be rendered constitute 'gross income' in the year of assessment during which they are received, provided they are not of a capital nature.

In ITC 702 (1950) 17 SATC 206 the appellant taxpayer in pursuance of its business as technical consultants and advisors, had received during the year of assessment a payment of R25 000,00 satisfied by the issue of fully paid-up shares as consideration for services rendered during the year in supervising the erection of a factory and installing plant, and in addition, for undertaking to continue to render technical and advisory services to the company for a total period of ten years. The taxpayer claimed that only a proportion of the consideration should have been included in taxable income for the year in which the benefit was received, but in discussing the appeal, the Special Court held that as the sum of R25 000,00 was admittedly not of a capital nature and was received during the year of assessment, it was taxable income of the taxpayer in the year of its receipt.

This case deals with the other leg of ITC 703 (1950) 17 SATC 208 related to the company that paid the R25 000,00 which is discussed under the heading "Advance Payments - Deductibility" on page 107.

In another case, ITC 707 (1950) 17 SATC 224, an undertaker, who also carried on a funeral insurance business, conducted in addition a 'prepaid funeral scheme' for persons who were not eligible for acceptance into the insurance fund. The prepaid funeral scheme consisted simply of receiving payments in advance for a funeral to be supplied at a later date. The Special Court held

that those advance payments received constituted ordinary income of the business which was taxable in the year of assessment when received, the money received not having been placed into a trust fund, but at all material times the taxpayer having dealt with it as his own money.

Furthermore, a monumental mason who received advance payments for tombstones was not entitled to make any deductions in respect of the estimated cost of tombstones to be erected at some future dates, subsequent to the tax year of assessment in which the advance payments were received, as such a deduction does not represent expenditure 'actually incurred' in terms of the provisions of Section 11(a) of the Income Tax Act (Special Court Decision, 12 September 1960, Case No.6009).

From the above it can be seen that particular consideration must be given to the tax consequences arising from amounts received in advance of the incurring of expenditure related to such income. The taxpayer may well find himself in a position of receiving taxable income in year one, on which he would have a liability for income tax, and in year two when he incurs the expenditure relating thereto, he may have little or no taxable income to absorb such expenditure and end up with a tax loss which may take a long time to work off, or even be lost due to the cessation of trade.

In valuing a business with income received in advance, one would have to consider whether any special allowance need be made for the tax consequences surrounding such receipts.

Preferably, such amounts should be received and held in trust by a third party or, if received by the taxpayer, they should be received on loan account with no vesting rights in favour of the recipient taxpayer attaching thereto.

The matching concept normally applicable in accounting does not apply to taxation where the taxation of amounts received has no bearing upon and is not affected or influenced by expenditure connected therewith or the timing thereof.

ADVERTISING EXPENDITURE

The amounts expended upon advertising must have been expended in the production of income and must be wholly and exclusively expended for the purposes of trade.

Comparing the cost of advertising in various well-known publications, the amount expended by the taxpayer for the insertion of an advertisement in a brochure to be published and distributed for the benefit of a public cause was held to be of such an extravagant character that the court raised inquiry as to why such an extravagant amount was paid. The taxpayer, being unable to discharge the onus of showing that the whole amount was expended in the production of income, and that the expenditure was wholly and exclusively laid out for the purposes of trade, the court found against the taxpayer and disallowed a large proportion of the expenditure in question.

- ITC 621 (1946) 14 SATC 498
- ITC 629 (1946) 15 SATC 93
- ITC 575 (1944) 13 SATC 476

In ITC 469 (1940) 11 SATC 261 a furniture dealer sought to deduct expenditure incurred on the erection of a model or 'dummy' house on a site hired under lease in a local showground's hall for the purpose of displaying his wares therein for a short period each year. The court held that although the purpose of erecting the structure was advertising, it was advertising of a permanent nature resulting in the creation of a capital asset and the expenditure was therefore not deductible.

Similarly, in discussing the taxpayer's appeal in ITC 217 (1931) 6 SATC 137, it was held that even if the expenditure incurred in respect of new and improved window lighting for a drapers and outfitters store could be regarded as a form of advertising, the expenditure incurred was of a capital nature and therefore not deductible for tax purposes.

In the recently heard case of CIR v Pick 'n Pay Wholesalers (Pty) Ltd (1987) 49 SATC 132, (3) SA 453 (A) the taxpayer who conducts a retail business throughout South Africa undertook to make a donation of R500,000 over a five year period, in instalments of R100,000 per annum to the Urban Foundation. The taxpayers' chief executive was also involved with the Urban Foundation. On announcing the donation favourable media publicity was acquired by the taxpayer as well as the Foundation who sought to launch their fund raising campaign with this donation. No media coverage was subsequently obtained. The onus of proving that the donation was wholly or exclusively laid out or expended for the purposes of trade fell upon the taxpayer who was unable to provide conclusive proof, the donation made having a dual purpose. Only the first years instalment from which publicity was obtained was allowed as a deduction.

ANNUITIES

All annuities received or accrued from a source within or deemed to be within the Republic of South Africa, are taxable in the hands of the recipient thereof in terms of their specific inclusion in the definition of gross income in Section I of the Income Tax Act.

The source of an annuity is the place where the contract or will was entered into irrespective of where the source of the underlying income or funds may be derived from in order to service the community.

Furthermore, in view of its specific inclusion in gross income, an annuity is fully taxable for normal income tax purposes, irrespective of the fact that it may flow wholly or partly from income which may otherwise be exempt from taxation or partly exempt from taxation, or which may arise from capital funds.

Thus where one receives an annuity in exchange for a capital sum, the annuity is subject to income tax in the hands of the recipient. However, a concession was introduced in 1973 by the introduction of Section 10A to the Income Tax Act in respect of the capital element of an annuity purchased from an insurer in the course of such insurer's insurance business.

Where the regular annual or monthly payments receivable by a taxpayer represent a return of capital deposited and the taxpayer always retains a right to claim any balance of capital deposited not otherwise repaid or extinguished, such regular receipts represent a return of capital which is not taxable in the recipient's hands.

This position must not be confused with what is commonly referred to as an 'annuity certain' where the consideration paid is completely lost to the purchaser taxpayer, and in substitution therefor, an annuity become payable to the taxpayer or his nominated successors for a fixed period of time. An annuity so payable is subject to taxation and where applicable the provisions of Section 10A referred to above may apply, causing the capital element of the annuity receipts to be exempt from taxation.

Should the consideration payable in respect of the acquisition of assets consist of an annuity, that annuity is taxable in the hands of the recipient but is not a deductible expense of the person liable for the payment. As the annuity is a consideration for the acquisition of capital it is not an expense incurred in the production of income derived from the use of such capital.

In the case of Lambson vs. CIR (1945) 14 SATC 57 (CPD), the taxpayer as consideration for the right to acquire ownership of a hotel business in terms of an option given to him in terms of his deceased father's will, entered into an agreement whereby he assumed personal liability for the payment of certain annuities provided for in the will of his deceased father. The court held that the annuity payments which the appellant was now obliged to make, superceded the terms of the will and constituted a portion of the purchase price expended in the acquisition by him of an income-producing asset, the hotel business. The annuity expenditure was thus of a capital nature and not a deductible expense for income tax purposes.

The decision in the case of Holley vs. CIR (1947) (3) SA 119(A) 14 SATC 407 is, however, an important decision. In that case, assets were bequeathed on condition that the heir pay an annuity to the surviving spouse. It was held that an amount of income derived from the assets bequeathed, up to the amount of the annuity payable, was not income accruing to the heir. The income backing the annuity accordingly accrued to the surviving spouse and not to the taxpayer heir, who was only

required to pay over the annuity, since the assets burdened, against which the annuity was chargeable, was under his control merely as a fiduciary. The deceased had created a fideicommissum in favour of his widow over all of the assets bequeathed to the taxpayer.

In the case of ITC 864 (1958) 22 SATC 387 a similar position arose with regard to an annuity payable to the widow of a deceased partner in a professional practice by the surviving partners under the provisions of a partnership agreement. The Special Court, however, distinguished this case from the case of Holley vs. CIR (1947) (3) SA 119 (A), 14 SATC 407, expressing the view that a person cannot dispose of, or create, a fideicommissum in respect of the fruits of the labour of a fiduciary. The court held that:

> "The carrying on by a professional man, such as an architect, of the practice of his profession and the earnings of such a professional man, cannot be regarded in the same light as the carrying on of, and the profits of, a commercial undertaking which is the sense in which the word 'business' is used in Holley's case and in other cases."

The partnership profits could therefore not be decreased for income tax purposes by the annuity payable to the widow.

The above must, however, not be confused with the position of the widow who is entitled to the usufruct of certain assets, the bare dominium in which may vest in her children. The waiver, by the widow, of her usufruct on condition that she shall receive a fixed income is linked with the income of the assets and the payment to the widow of her income forms a legitimate deduction in the hands of the persons in whose favour the usufruct was waived, in the determination of the taxable income derived from the use of those assets ITC 435 (1939) 10 SATC 451.

Where the taxpayer disposed of a business in consideration for the payment to him by the purchaser

of a fixed sum of money per month for his, the taxpayer's, lifetime, the Special Court held that the amounts in question clearly constituted an annuity and as such fell within the definition of 'gross income' ITC 713 (1950) 17 SATC 337.

The Income Tax Act, unfortunately does not define the meaning of the term 'annuity'. In ITC 761 (1952) 19 SATC 103, the Special Court found it necessary to determine the meaning of the term. After reviewing various authorities, the Special Court found that the main characteristics of an annuity are:

a) that it is an annual payment (this would probably not be defeated if it were divided into instalments);

b) that it is repetitive in that it is payable from year to year for, at any rate, some period;

c) that it is chargeable against some person or entity.

It was further held in ITC 384 (1937) 9 SATC 446 that where an annuitant becomes entitled to both an annuity and the corpus of the entity over which the annuity is chargeable, then the merger of both such interests causes the cessation of the annuities and the income receivable thereafter arises from the ownership of the assets. The application of the principle established in this case is particularly useful where income derived from assets by, say, an estate, is in the form of tax-exempt or tax-free income, e.g. dividends, which becomes fully taxable in the hands of the annuitant due to the annuitant receiving an annuity.

From the above-mentioned cases it can be clearly seen that annuities receivable or payable have peculiarities when taxation is considered.

ANNUITIES - NRST IMPLICATIONS

The recipients of annuities from estates or trusts are liable for normal tax on the full gross value of the annuity.

Where an annuity is derived by a non-resident annuitant either wholly or partly from dividends received by the estate or trust, non-resident shareholders' tax is not payable on any portion of such annuity.

ASSETS - WASTING

No allowance is deductible for the amortisation or depreciation of a wasting asset, such as a gold or coal mine, or a natural forest where the exhaustion is caused by the acts of the owner.

- CIR vs. George Forest Timber Co Ltd (1924) 516 AD, 1 SATC 20.

BAD DEBTS

Bad debts incurred in respect of a previous or abandoned business of the taxpayer, which are proved to be irrecoverable, may be claimed as a deduction from income from other sources.
- Merchant vs. Commissioner of Taxes (1944) (SR) 153.

Of course, in such an instance only such debts as were previously reflected as income in previous years is deductible. In addition, any expenditure which may be incurred in collecting these debts will also be allowed as a deduction.

BAD AND DOUBTFUL DEBTS - ARISING FROM ASSETS TAKEN OVER IN SETTLEMENT OF AN AMOUNT OWING

A trader may find that he is compelled to accept an asset, which in his hands is of a 'non-trading' character, in settlement of a debt due to him by a trade debtor for goods supplied in the ordinary course of his business.

Where steps are taken to realise or dispose of the asset acquired as soon as possible any shortfall realised in respect of the amount of the original debt is allowable as a bad debt in determining the taxable income of the trader. However, any surplus that may arise would not constitute taxable income due to the acquisition and disposal of that asset in such circumstances being clearly a transaction which was not entered into with a profit-making intention and not in the ordinary course of the trader's business. Should the trader decide to retain the asset acquired indefinitely, then to the extent he is able to establish a shortfall in the value of the asset on its acquisition as compared to the amount of the trade debt for which it was exchanged, he is entitled to claim a bad debt. Any subsequent shortfall or surplus realised would be regarded as having arisen from the sale of the capital asset, the asset having assumed the character of a fixed or capital asset in his hands.

Where the trader in the normal course of his business enters into and accepts barter or trade-in transactions in full or part settlement of his trade debts, the assets so acquired constitute stock-in-trade and must be brought into account in the normal manner through his trading account.

BAD AND DOUBTFUL DEBTS - BUSINESS ACQUIRED OR DISPOSED OF

When a business is acquired by way of the acquisition of assets, debts taken over from the seller which are subsequently found to be irrecoverable by the purchaser are not allowed as deductions in the hands of the purchaser in terms of Section 11(i) or 11(j) of the Income Tax Act. The debts acquired form part of the assets of the business acquired and have not come about in the purchaser's hands in the ordinary course of his business. Any subsequent losses incurred due to the irrecoverability of those debts is a loss of a capital nature - (ITC 95 (1927) 3 SATC 242.

Accordingly, care must be exercised when valuing debtors to be acquired. Often, the seller will indemnify the purchaser against all such losses and on the reversion of the debt to the seller, who had received the debt in the ordinary course of his business, the debt will once again be deductible in the hands of the seller.

Similarly, an heir has no entitlement to deduct a bad debts or doubtful debts allowance in respect of debts inherited which subsequently prove to be irrecoverable. Therefore it is most important to make an adequate provision for such losses in the estate from which the asset is inherited before the award of the inheritance, failing which no allowance will be available to any taxpayer.

In the event of a taxpayer who has been carrying on business for his own account admitting a partner, such incoming partner is not entitled to any deduction in respect of irrecoverable debts written off as bad where the debts were incurred prior to his admission to the partnership, as such debts had not been included in his income.

With regard to the original sole trader, it must be borne in mind that the deduction provided for in Section II(i) of the Income Tax Act relates to debts "due to the taxpayer". Upon admission of the partner, the outstanding debts taken over by the partnership become due to the partnership and are no longer wholly due to the sole trader as before.

In respect of such debts written off as bad debts, the original sole trader may therefore only deduct the share of the bad debts borne by him in terms of the partnership agreement.

Similar principles apply in the case of the retirement or death of any partner of a partnership.

Should the seller of a business retain the book debts for collection on his own account, the amount of any bad debts incurred are allowable as a deduction in the determination of his taxable income, even if such bad debts are claimed as a deduction at any time subsequent to his disposing of the business. However, if the book debts were sold subject to the purchaser having recourse to the seller and on some of the debts proving to be bad, the seller is required to refund a portion or the whole of the purchase price of the debtors, the amount so refunded under the guarantee is not an allowable deduction, it being a capital loss ITC 466 (1940) 11 SATC 251.

However, it is usual for the agreement between the purchaser and seller to provide, in the event of the seller being compelled to make a payment to the purchaser under such a guarantee in respect of irrecoverable debts, that the purchaser is entitled to the re-cession of such debts. Where the debts are so re-ceded to the seller, the debts once again are deductible in terms of Section 11(i) of the Income Tax Act as bad debts, as they belong to the seller in whose hands they were previously included as income.

In the case of SIR vs. Kempton Furnishers (Pty) Ltd (1974) (3) SA 36A, 36 SATC 67, the appeal

court held that the provisions of Section 11(i) were satisfied where trade debts were sold subject to a resolutive condition in terms of which the seller was obliged to repossess so much of those debtors as the purchaser was unable to collect within a specified period of time, and to refund the purchaser the face value of those outstanding debtors. The seller subsequently wrote-off as bad debts those debts repossessed in terms of the agreement. The court held that:

> "Where the sale of a trading debt, subject to a resolutive condition, is dissolved by reason of the fulfilment of the condition, the sale of the debt must for all practical purposes, including the purposes of Section 11(i), be regarded as not having taken place, although the sale, when concluded, was perfecta. In such a case the debt cannot be regarded as having changed its character from that of an ordinary trading debt" (at page 71).

The loss incurred when a taxpayer sells his book debts at the time of his selling his business or ceasing to trade is not deductible from his income since it is not incurred in the production of income but subsequent thereto and in the sale of the capital assets.

However, where the taxpayer, in order to obtain liquidity for his ongoing business, sells his book debts to a finance or credit company at a discount and in so doing incurs a loss, such loss is deductible in terms of Section 11(a) of the Income Tax Act, as being a loss incurred in the production of income.

BAD AND DOUBTFUL DEBTS - DOUBTFUL DEBTS

A deduction may be made for debtors, the collection of which is considered to be doubtful. This deduction is in the form of an allowance calculated at a rate, usually not exceeding 25 per cent of the listed doubtful debts, according to the circumstances of the case and the nature of the debtors. This deduction is provided for by the provisions of Section 11(j) of the Income Tax Act. As the deduction is in the form of an allowance, the allowance for doubtful debts in one year of assessment must be added back to the income of the subsequent year when a new allowance may be claimed.

Very often, taxpayers list the accounts which they consider to be doubtful instead of the total amounts owing by those debtors. As the allowance is only a percentage of the listed debtors the deduction then becomes a smaller amount than otherwise deductible. The full amount of all debtors where the recoverability of any portion of such debts is in doubt should be listed in order to compute the largest allowance which is deductible in respect of those debtors.

Where the cessation of business is as a result of the death or insolvency of a taxpayer, such taxpayer is still entitled to a deduction in terms of Section 11(j) of the Income Tax Act, of an allowance for doubtful debts as at such date of death or insolvency. As death or insolvency causes the cessation of the existence of a taxable entity, the allowance granted as at the date of such death or insolvency, is not in the subsequent year of assessment, included in the taxable income of any entity.

Similarly, in respect of debts incurred prior to insolvency and which prove to be irrecoverable after the sequestration of the taxpayer's estate, no deductions may be made for bad debts or for a doubtful debts allowance in determining the taxable income of the insolvent estate or the taxable income of the insolvent person.

BAD AND DOUBTFUL DEBTS - IRRECOVERABLE LOANS

The Rhodesian High Court in dismissing the appeal in the case of Salisbury Board of Executors Ltd vs. Commissioner of Taxes (1941) (SR) 147, 12 SATC 1 held that the appellant company had failed to establish that the lending of money was an adjunct and auxiliary to its business as an estate management company. The intention of the company, as set out in its Memorandum of Association, was to deal with its capital by means of its investments as fixed capital and the practice of the company did not show that this intention had changed to one of carrying on the business of a lender of money. The loss incurred when a loan debtor died insolvent and the security held proved to be inadequate was therefore a loss of capital and not deductible.

In the case of a firm of attorneys and conveyancers it has been held that losses sustained in respect of amounts advanced to clients, who were builders, until mortgage finance could be arranged for them by the firm, had been properly disallowed as a deduction from taxable income. The court observed that although such advances may have been connected incidentally with the earning of fees, the losses represent capital lent to the builders and, if such amounts are lost, it is a capital loss. - ITC 478 (1940) 11 SATC 337.

Generally, amounts laid out to secure business is expenditure of a capital nature and any loss incurred from such actions is a loss of a capital nature and not an allowable deduction. However, where it can satisfactorily be established that it is the custom of a business or profession to make advances to customers or clients as an integral part of the business carried on for the purpose of securing or retaining business connections, such advances, if subsequently found to be irrecoverable, are allowable deductions. The losses which may be incurred by an auctioneer in advancing funds to their customers to purchase at their auction sales are held to be so deductible, as are disbursements of expenses made by a professional person on behalf of a client.

BEARER SCRIP - NRST IMPLICATIONS

In terms of the provisions of Section 42(l)(iv) of the Income Tax Act, dividends paid or payable to the holder of bearer scrip, irrespective of whether the holder of the scrip is resident within or outside of South Africa, attract a liability for non-resident shareholders' tax on such dividends.

The effect of this provision is that a South African resident who is the owner of bearer scrip issued by a South African registered company is liable to have non-resident shareholders' tax deducted from any dividends received by him on such scrip. Accordingly, it is prudent for South African residents to refrain from acquiring bearer scrip unless special circumstances exist.

BUILDING CONTRACTS

In a fairly early Special Court decision in ITC 156 (1929) 4 SATC 308, the principles relating to the taxation of the proceeds of a building contract were enunciated. These principles are that if, in terms of a building contract, no payment shall become due and payable until it has been certified by the architect, then the individual payments in respect of the contract only accrue to the contractor as at the date of the architect's certificates in respect of each payment.

In terms of common law, improvements to land attach to such land and become the property of the owner of the that land. Furthermore, the same principle applies to building materials delivered to the building site even though not yet attached to the land.

It has been the practice of building contractors and engineering concerns to value work-in-progress not yet certified as being due and payable for accounting purposes, and for Revenue to allow a deduction for the value of such work-in-progress until certified. Accordingly, the construction and engineering industry have been able to enjoy a deferral of the taxation on the value of the work-in-progress, until its realisation on certification.

With effect from years of assessment ending on or after 1 January 1991 the value of work-in-progress is to become taxable. However, to ease the pain to the taxpayer, a transition period of ten years will apply during which the values of work-in-progress is to be phased in in terms of a new Section 22 (3B) to the Income Tax Act.

Accordingly, in doing any valuation of a business of a building contractor or engineering concern, cognizance must now be taken of the effects on the cash flow and financing requirements of the company to meet the additional tax burden which will no longer be deferred as in the past. Even though phasing in will help initially, substantial taxation may become payable a lot earlier than would otherwise have been the case.

CESSATION OF FARMING

Where a farmer disposes of his farm together with all the loose and movable assets, the Special Court rejected the farmer's contentions that the sale price realised for the livestock and other movables previously written off and now included in the sale was an accrual of a capital nature and did not constitute income derived from farming operations. It was held in ITC 638 (1947) 15 SATC 225 and, ITC 704 (1950) 17 SATC 211 that a sale of farm assets by a farmer is the final transaction in respect of farming operations, and the proceeds cannot be excluded from the operations which have resulted in the transaction itself.

In ITC 716 (1950) 17 SATC 344 the Special Court concluded that even if farming operations were carried on solely with the objective of producing wool, the proceeds of the sale of sheep with a view to ceasing farming operations constituted "gross income" as defined and was not of a capital nature. There is no distinction between sheep kept for wool-raising activities as compared to those kept for sale purposes.

CONTRACTS - BUILDING

If, in terms of a building contract, no payment becomes due and payable until it has been certified by the architect, the principles enunciated in the decision quoted in ITC 156 (1929) 4 SATC 308 apply and the individual payments in respect of the contracts accrue to the contractor as at the date of the architect's certificate in respect of each payment.

CONTRACTS - CANCELLATION OF

The amount paid to cancel a contract for the purchase of goods for the purpose of avoiding a loss on resale owing to trade conditions is an allowable deduction.

Similarly, an amount paid to cancel a contract for the sale of goods, such sale arising in the ordinary course of business, is a trading loss and as such allowable as a deduction.

Any amount received as compensation for breach of a contract of employment is taxable on the grounds that it is an advantage granted in respect of employment and also in the nature of a quid pro quo for the right to salary and/or commission. It is not converted into a receipt of a capital nature by the mere fact that it is paid in a lump sum instead of being paid as the salary and/or commission under the contract falls due. Neither expenditure nor receipts which are paid or received in the discharge of a continuous business liability lose their nature as income payments or receipts by reason merely of their commutation by a single payment.

A taxpayer who had contracted to hire certain neon light displays for advertisement purposes for a period of five years, before the expiry of that period decided to close down his business and paid to the lessor an agreed sum as consideration for cancelling the contract. The amount so expended was held to be inadmissible as a deduction under Section II(a) having been incurred directly as a result of the decision to cease trading and not for the purpose of earning income.

For similar reasons, in ITC 852 (1957) 22 SATC 187 it was held that a loss incurred by the appellant in disposing of redundant office equipment did not result from a scrapping within the meaning of Section II(j) and was therefore not deductible loss.

In the course of his business as a country storekeeper, the appellant in ITC 43 (1925) 2 SATC 115 accepted an offer from suppliers for the future delivery of grain. Owing to a sudden rise in prices the suppliers were faced with a loss on their contracts and they tendered certain sums as consideration for the cancellation of the contracts, which the appellant accepted. On appeal it was held that the consideration constituted income derived by the appellant from transactions conducted within the scope of his business which was subject to tax as revenue receipts.

CONTRACTS - OVERSEAS CONTRACTORS

An overseas contractor performing services of work in South Africa under ordinary contract is taxable on the profits earned. The basis of assessment of taxable income is either:

- the profit actually derived from the work performed in South Africa; or

- the proportion of the profit derived from all sources in the ratio that assets employed in South Africa bear to total assets in his business as a whole.

The alternative basis is generally only to be applied when records reflecting the actual profit earned in South Africa have not been kept and the contractor is unable to submit an accurate statement of his income from South African sources.

However, where an overseas contractor undertakes to erect in South Africa machinery purchased under a contract entered into outside South Africa and the purchase price includes the cost of erection, any profit made by the contractor on the cost of erection is not taxable in South Africa. The salaries or wages paid to the contractor's employees engaged on the work of erection in South Africa is however deemed to be income derived from a source within South Africa.

CUM INTEREST OR CUM DIVIDEND - REDUCTIONS

Where government, municipal or similar stocks or company shares are purchased cum interest or cum dividend, no amount may be deducted from the interest or dividend actually received by the purchaser, in respect of any accrued interest or dividend taken into account in determining the purchase price of those stocks or shares - ITC 268 (1933) 7 SATC 159.

Accordingly, when purchasing or selling such stocks or shares the period expired since the last interest or dividend payment should be carefully considered.

It is seldom found in practice that a purchaser or valuer has made any allowance for taxation on the income accrued to the date of purchase and sale. Accordingly an investor may receive a better after-tax selling price, all of which would be on capital account, if he sold shortly before the payment of interest or a dividend, as compared to receiving the interest or dividend, paying taxes thereon and then selling the stock on the interest or dividend determination date free of any accrued income.

A valuer of such stocks or shares should, however, carefully evaluate the tax effect of the transaction at valuation date. Unfortunately this is more often than not overlooked, resulting in an excessive purchase price being paid in respect of the income accrued due to the liability for taxation on the income accrual not have been adjusted for.

Similarly it can be held that the amount realised on the sale or redemption of building society share investments, prior to their normal maturity dates, does not include any taxable interest or dividends. The interest or dividend is merely a calculation to determine the price of the shares for the purpose of the sale, there being, as a matter of fact, no interest due on the shares at the time of the sale.

The aspect of whether expenditure has been "actually incurred" must be borne in mind in such circumstances. (See "Expenditure and Losses Actually Incurred" below).

DAMAGES - DEDUCTIONS

In the case of Port Elizabeth Electric Tramway Co Ltd vs. CIR (1936) 8 SATC 13, it was held that compensation paid to the dependants of a driver employed by a carrier such as a tramway or omnibus proprietor who was killed in carrying out his duties or in connection with injuries suffered by passengers and wayfarers, is an expense incidental to the business carried on by the employer and is allowable.

ITC 590 (1945) 14 SATC 133 followed the principles laid down in the Port Elizabeth Electric Tramway case, in allowing as a deduction that portion of the compensation claimed by the widow of an employee of the taxpayer, which was in excess of the amount covered by insurance, in respect of a motor accident resulting in the employee's death while travelling on the company's business in a car driven by another employee of the company. The court was satisfied that the risk of such accidents and claims for damages were incidental to the conduct of the appellant company's business for the purposes of which a large number of motor vehicles were maintained.

Compensation paid by a laundry for damage to or loss of articles entrusted to its care is an allowable deduction.

However, compensation paid by an agent in respect of a loss which was sustained by the principal owing to the agent's failure to carry out the principal's instructions to cover the risk by insurance is not considered to be an expense attributable to a risk inherent in the agent's business and is not allowable as a deduction.

Dealers in second-hand goods are liable to the risk of purchasing stolen goods. If a loss is sustained as the result of such goods being reclaimed by the rightful owner and it is proved that the dealer

could not reasonably have been aware of the fact that they were stolen, the amount of the loss will be allowed as a deduction.

The risk of burns and electric shock inherent in the business of any taxpayer would permit any damages required to be paid, to be claimed as an allowable deduction from income.

Similarly, nursing home proprietors are exposed to the constant risk of liability for damages through the negligence of their nursing staff and any such damages incurred may accordingly be allowed as a deduction.

However, in the case of Joffe & Co (Pty) Ltd v CIR (1944) 13 SATC 354, the court found that damages paid by a reinforced concrete engineering company in respect of the death of workman in an accident resulting from negligent construction work by the company were not allowed as a deduction. As it had not been established that negligent construction work was a necessary concomitant of the trading operations of a reinforced concrete engineer, the expenditure had not been incurred as incidental for the purposes of the company's trade.

Similarly, in the case of ITC 658 (1948) 15 SATC 498, as the result of failing to adhere to the specifications in building a block of flats, the external walls revealed dampness and the building contractor incurred expenditure in respect of damages. The damages were not allowed as a deduction as there was nothing to suggest that negligence in observing the plans and specifications, and the liability consequent thereon, were inevitable or necessary concomitants of the contractor's trading operations.

In ITC 661 (1948) 15 SATC 509 it was held that damages incurred by a manufacturing company in

consequence of legal proceedings instituted by a purchaser for failure by the company to deliver certain goods in accordance with the terms of a contract, were inadmissible as the expenditure was not incurred in the course of a business operation undertaken for the purpose of earning income.

Damages awarded against a garage proprietor were held to be inadmissible as a deduction where they had been incurred as a result of an accident in which a customer's car was extensively damaged while being put to unauthorised use by an employee of the garage, as the expenditure had not been incurred in the production of income.

In ITC 461 (1940) 11 SATC 191, the court held that an amount paid in settlement of a claim for damages was allowed where the appellant company, carrying on the business of hiring out cinematograph films, had become involved as defendant in an action for alleged wrongful repudiation of a verbal agreement which the plaintiff claimed had been entered into for the hire of certain films.

The taxpayer in ITC 30 (1922) 2 SATC 51 had supplied to certain of his customers, a brand of sheep dip for which he was the agent. Following upon the death of sheep alleged to have been poisoned by the dip, he was faced with a claim for damages and therefore had exhaustive analytical investigations made, the cost of which he claimed as a deduction. On appeal, it was held that the expense had not been incurred in the production of income and was therefore not deductible.

In the ordinary course of his business the taxpayer in ITC 49 (1926) 2 SATC 122 sold petrol lamps subject to a guarantee. One such lamp exploded causing injuries to a purchaser, who brought an action for damages against the taxpayer. Damages and costs were awarded against the taxpayer and the expenditure involved was held, on appeal, to have been incurred in the production of income and was therefore deductible.

DAMAGES - INCOME

Damages in respect of breach of a contract of purchase and sale are presumed to put the recipient in the same position as if the contract had been carried out. In other words, they represent the potential profit that might have accrued on the sale of the goods if they had been supplied. Accordingly any such damages are clearly receipts arising out of a contract of purchase and form part of taxable income.

In dismissing the appeal in ITC 723 (1951) 17 SATC 496 the Special Court held that an amount received by way of damages or by way of settlement of an action for damages is income and not capital if the transaction out of which the claim for damages arose is a transaction which, had it been completed, would have resulted in income and not a capital gain or loss as the case may be.

On the other hand, it is interesting to note that the appeal was allowed in an earlier case, ITC 294 (1933) 7 SATC 347 where the taxpayer had received an amount as damages from a company which refused to carry out a contract in terms of which it was required to give employment to the appellant for a certain period at a specified salary. The court held that as the damages had been awarded in respect of a refusal to enter into a contract of employment, and not for the wrongful termination of a contract of employment, the amount was in the nature of a capital receipt and, as such, was not taxable.

DEMOLITION - LOSS ON

The appellant's business in ITC 286 (1933) 7 SATC 322 embraced both the dealing in property and the erection of buildings for letting purposes. In respect of a building so erected, from which rentals had been derived for many years, the appellant sought to deduct a loss in respect of the difference between the written-down value of the building and the proceeds from the sale of the materials resulting from its demolition to make way for a new building. The court, in dismissing the appeal, held that the transaction was not one in the normal course of the taxpayer's business and, if incurred, was a loss of a capital nature which had not been incurred in the production of income derived from that business.

DEPOSITS - INCOME

Deposits received by a hotel keeper in respect of board paid in advance or retained as damages for the payer's failure to take up bookings are taxable in the year of assessment in which they were received.

The same applies to any rentals or other income received in advance. However, if such amounts are received by some third party and held in trust pending the occurrence of some event, after which they vest in the taxpayer, then in such event only when the amounts vest in the taxpayer are they taxable in the taxpayer's hands.

DIRECTORS' REMUNERATION - GENERAL

In ITC 537 (1942) 13 SATC 104 the appellant company charged in its accounts for the year ended 30 June 1941 R2 400 in respect of fees for services rendered by its directors during that year and for the 10•5 months of the preceding year of assessment (i.e. from its date of incorporation to 30 June 1940. On appeal it was held that the Commissioner was correct in declining to allow as a deduction for the 1941 tax year, R1 120 which was attributable to the 10•5 months ended 30 June 1940 as only expenditure incurred in and relating to the current year is deductable in that year. It was observed that the appellant might have made provision for the fees in its 1940 financial statements but had deliberately refrained from doing so and the court could not request the Commissioner to reopen the assessment for that year.

Accordingly, directors' remuneration paid or accrued in any one year should only relate to that year in order to be tax deductible.

ELIMINATION OF COMPETITION

Any payment made in order to eliminate competition constitutes expenditure of a capital nature and is not deductible in terms of Section 11(a) of the Income Tax Act.

In ITC 503 (1941) 12 SATC 156 the taxpayer, a member of a specific trade association, made a substantial contribution towards expenditure incurred by the association for the purposes of enabling the association to eliminate competition from a non-member company carrying on business to the disadvantage of the association's members. In dismissing the appeal the court held that the elimination of a competitor was an advantage of an enduring nature in which all the members of the association shared and that the expenditure incurred was of a capital nature and so not allowable as deductible expenditure.

In ITC 359 (1936) 9 SATC 182 (U) the taxpayer entered into an agreement with a company manufacturing products similar to those of the taxpayer, in terms of which that company undertook to cease the manufacture of those products and to dispose of its factory and plant in a manner which debarred their future use for that purpose. The taxpayer agreed to pay to the company an amount equal to any loss incurred in the disposal of the factory and plant. The court, in dismissing the taxpayer's appeal against the disallowance as a deduction of the amount paid in pursuance of the above, held that the expenditure, having been incurred in order to form a source of additional or increased revenue, constituted expenditure to secure an additional capital asset for the enduring benefit of the taxpayer's trade and was therefore not deductible.

In ITC 304 (1934) 8 SATC 85, an amount paid by the taxpayer to compensate a trade competitor for agreeing to close his rival branch business was held to constitute expenditure of a capital nature

incurred for the protection of the taxpayer's business by the elimination of competition and, therefore, not an allowable deduction.

However, in an earlier case ITC 245 (1932) 6 SATC 374 the Special Court held, on the particular facts of that case, that a fixed sum payable annually was allowable as a deduction where the payment was made to the controlling shareholder of another company in terms of an agreement entered into between the parties for the mutual limitation of trade.

EXPENDITURE AND LOSSES ACTUALLY INCURRED

A valuer must give consideration to provisions made by a taxpayer for expenditure or losses. In order to qualify for deductibility as an expense, such expenditure or losses must actually have been incurred.

The recently decided case of ITC 1495 (1990) 53 SATC 216 considered the deductibility of "expenditure and losses actually incurred" where a taxpayer sought to deduct an amount in respect of leave pay accruals. The employees' conditions of employment provided for the employees to have a period of nine months after the expiry of a leave cycle to take accrued leave, failing which such leave would be forfeited. The court held that it was the leave that had accrued and not the remuneration in respect thereof, and that at a tax year end the only liability incurred by the taxpayer was to allow leave to be taken provided the respective employees timeously exercised their rights. Accordingly, the court held that as the leave pay accrual was only a contingent liability, which may or may not arise in the future, it could not be said to be expenditure "actually incurred" and it was therefore not deductible expenditure.

FARMING - CLEARANCE AND PREPARATION OF GROUND COSTS

Where a taxpayer is about to embark on farming operations, the timing of the commencement thereof is important as in terms of departmental practice, the costs of clearing and preparing land for such farming purposes may be deductible from income provided that in the year in which such expenditure is incurred, income is derived from farming operations.

Where no such farming income is derived in the year of incurring such expenditure, the expenditure is not deductible and regarded as being of a capital nature.

FARMING - MEANING OF

The term "farmer" is not defined in the Income Tax Act.

In ITC 586 (1945) 14 SATC 123 the Special Court were required to decide whether the taxpayer company, which conducted business as livestock auctioneers, produce brokers and estate agents, was entitled to be assessed as a farmer in respect of its activities in purchasing store cattle, grazing them for periods of up to six months and then selling them, or whether these activities constituted livestock speculation business activities. In deciding that on the particular facts of this case that the taxpayer was carrying on farming operations, the court based its decision on the conclusion that it is the business of a farmer to acquire a product in one state, to transform it into an improved product and then to sell it. The taxpayer's activities in acquiring cattle capable of improvement and the grazing of them for considerable periods on land leased for this purpose, as distinct from merely providing storage, so that they may be sold at anticipated enhanced values, constituted the carrying on of the business of farming. The taxpayer was applying its skills to acquire a particular asset, work on the asset and through farming methods, realise it at a profit. The court, in distinguishing the livestock speculator, observed that the speculator is only really interested in the marketing of livestock, he does not usually retain them for a long time and he does nothing to improve the quality of the livestock.

In ITC 208 (1931) 6 SATC 55 the taxpayer's principal occupation was that of a teacher. He owned a smallholding where he grew vegetables and other crops and also cultivated fruit trees. During the year of assessment the taxpayer sold a small amount of vegetables and fruit on the local market and also consumed some produce in his own household. The expenditure incurred on cultivation and maintenance as well as interest charges greatly exceeded the value of the produce marketed and consumed. The taxpayer sought to claim the net loss as a set-off against his income as a teacher

on the grounds of his carrying on the business of a farmer. In allowing the taxpayer's appeal the Special Court concluded that each case must be judged on its own merits, and, the court having made an inspection of the property in question, it was held that although the operations carried on were not yet on a profitable scale, they did constitute the taxpayer's subsidiary occupation of farming undertaken with a genuine intention to develop an entity that would ultimately be profitable.

Where the consideration for the letting of a farm consists of a percentage of the farm produce, including crops and/or livestock, and not a cash payment, the lessor is deemed to be carrying on farming operations in partnership with the lessee and is accordingly assessable as a farmer - ITC 166 (1930) 5 SATC 85.

In ITC 732 (1951) 18 SATC 108 it was held that where a farmer let portion of his farm for an annual rental payable in cash, to a tenant who carried on farming operations thereon, the rental received did not constitute income derived from farming operations.

Each partner in a partnership carrying on farming operations must make his own choice of standard values under the provisions of the Income Tax Act. However, a farmer who carries on farming operations both as a member of a partnership and for his own account must select the same standard values for the livestock of his separate ventures.

GIFTS AND GRATUITIES - DEDUCTION

Gifts and gratuities or bonuses which are not taxable in the hands of the recipient are generally not allowable deductions from the income of the payer being deemed to be gifts or payments of a capital nature provided they are not related to services rendered by the recipient.

In W F Johnstone and Co Ltd vs. CIR (1951) (2) SA 283 (A) 17 SATC 235 the Appeal Court accepted as a legitimate finding of fact the conclusion of the Special Court that, on the evidence, lump-sum payments made to certain employees by the company upon their retirement had been awarded ex gratia in recognition of services rendered. That being the position the gratuities did not constitute "expenditure and losses actually incurred in the Union in the production of income" within the meaning of the Income Tax Act nor were they "wholly and exclusively laid out or expended for the purposes of trade".

In ITC 590 (1945) 14 SATC 133, the Court rejected a claim to deduct certain payments voluntarily awarded to the widows of two employees who had died while in the company's service. The company minutes recorded the payments in appreciation of past services rendered by the deceased. As the expenditure was not actually incurred in the production of income and was not wholly and exclusively laid out for the purposes of trade, the amounts paid were not allowable as a deduction.

ITC 618 (1946) 14 SATC 480 was also decided on similar principles.

The decision in the Southern Rhodesian High Court case of Provider vs. Commissioner of Taxes (1950) (4) SA 289 (SR) 17 SATC 40 provides authority to the view that such expenditure incurred may be allowed as a deduction, if made in fulfilment of the terms of an agreement of service, the employer has made payments on the agreed basis to an employee on his retirement or to the dependants of a former employee.

INCOME - MISCELLANEOUS

In the case of Miller vs. CIR TPD 1952 (1952) (4) SA 765 (T) 18 SATC 347, the Court found that where amounts were paid to outgoing partners pending the release of those partners from their obligations under leases and other agreements, the amounts paid were analogous to interest or penalty payments in respect of the delay in settling the capital indebtedness and that they unquestionably bore the imprint of income.

An insurance agent won as a prize an amount offered in a competition amongst the agents of an insurance company by which he was employed. The prize was awarded to the agent who, during a period of time, incurred the largest amount of cover and secured payment of the largest premiums. The prize was also over and above normal commission remuneration. On appeal in ITC 117 (1928) 4 SATC 70 it was held that the prize was so directly related to the labour and wit expended by the taxpayer in carrying out his work that it must be regarded as a product thereof and therefore taxable as income.

In ITC 880 (1958) 23 SATC 234 it was held that an amount received by way of consideration for agreeing to an early repayment of an interest-bearing loan, took the place, and for tax purposes, the colour of the interest lost as a result of the early termination of the loan. Accordingly the amount received was taxable as income.

INSTALLATION EXPENDITURE

In ITC 480 (1940) 11 SATC 343 it was held that expenditure, consisting mainly of wages, paid by an engineer taxpayer to his own employees, for making and installing fixtures and equipment in the workshop of the business, constituted capital expenditure and was therefore not allowable as a deduction from income.

INTEREST DEDUCTION - GENERAL

The appellant in ITC 635 (1947) 15 SATC 117 had purchased a property which was bonded in favour of the seller for the balance of the purchase price. In terms of the bond the taxpayer undertook to pay to the mortgagee R12 000, in instalments of R80 per month during the lifetimes of the mortgagee and his wife. Thereafter no further payments were to be made even if the R12 000 had not been fully paid. It was further stipulated that the monthly payments to the mortgagee or his wife would continue even if in aggregate they totalled or exceeded R12 000. By the end of the year of assessment under review the appellant had made aggregate payments of R12 480 and he sought to deduct the R480 excess claiming it to be in the nature of interest. The court in dismissing the appeal held the amount in question to be on account of the purchase price and as such of a capital nature which was not deductible.

In CIR vs. Shapiro (1928) NPD 436 4 SATC 29 the taxpayer had borrowed money in order to acquire a shareholding which entitled him in terms of an agreement to the position of managing director of a company. In that capacity he was to receive a salary, house allowance and commission. The taxpayer sought to deduct the interest paid on the loan as an expense incurred in the production of the aforesaid income. On appeal it was held that the income was not produced by his shareholding in the company but by the services rendered in exercising his duties as managing director. The interest paid was therefore not deductible from the remuneration received.

In order to make a donation to his daughter the taxpayer in ITC 144 (1929) 4 SATC 223 raised a loan secured by the pledge of income-producing securities. On appeal it was held that interest paid on the funds borrowed was incurred in respect of a private or domestic expenditure. Furthermore,

the interest was not paid in the production of income, but was expended to preserve intact the taxpayer's existing income-producing assets and was therefore expenditure of a capital nature. ITC 831 (1956) 21 SATC 316 was similarly decided where assets were preserved and a loan raised against their pledge.

In ITC 301 (1934) 8 SATC 65 the taxpayer company purchased the entire shareholding in another company carrying on a business similar to that of their own operations which they wished to extend. In order to finance the purchase the taxpayer borrowed funds and sought to deduct the interest paid on the loan. In dismissing the appeal it was held that the interest paid was expenditure on a capital liability incurred by the taxpayer in purchasing shares and was not directly connected with the production of the appellant company's income from trade.

INTEREST DEDUCTION - PRIVATE RESIDENCE

Interest payable to a building society on a loan used to build or acquire a residence is not an allowable deduction from interest received on an investment with the building society taken up in order to raise the loan. Each transaction is separate and distinct. The loan interest is expenditure of a private nature which is not deductible and the income from the investment falls within the definition of income.

In ITC 846 (1957) 22 SATC 75 a taxpayer bonded his private residence in order to raise a loan which he used to acquire another home in a different area to which he then moved. He let his old house, and on claiming a deduction for the bond interest paid, against the rentals received, the interest was held to be inadmissible as it was undoubtedly incurred for the purpose of acquiring a private residence.

In ITC 829 (1956) 21 SATC 199 an attorney claimed as a deduction from his professional income interest on R4 000 of the bond over his private residence, claiming that he was obliged to retain R4 000 in his legal practice for business purposes. On appeal it was held that the test to be applied is the purpose for which the money was borrowed. On the evidence the money was used for private purposes and the appeal failed.

INTEREST PAYABLE - FUNDS RAISED TO PAY DIVIDENDS

In ITC 679 (1949) 16 SATC 348 it was held that interest paid on funds borrowed by a company in order to pay a dividend to shareholders cannot be said to have been expended in the production of income and is therefore not a permissible deduction from income.

It is interesting to note that for many years it has been departmental practice in the Revenue department to allow as a deductible expense from the income produced by inherited assets, interest on funds raised in order to liquidate estate duty attaching to the acquisition of assets from which income is to be derived.

However, interest payable on capital borrowed to liquidate legacies to third parties or for the acquisition of non-income producing assets, is not admissible as a deduction even though some of the assets would otherwise have had to be sold and the income on those assets would have been lost.

INTEREST PAYABLE - LOAN USED TO FUND PRIVATE EXPENSES

Interest paid on funds borrowed in order to liquidate liabilities of a private nature, even though revenue-producing assets may be pledged as security, is not allowable as a deduction against income from other sources.

INTEREST PAYABLE - LOAN USED TO PURCHASE SPECULATIVE SHARES

It is a department practice of the Revenue department to disallow as a deduction from income from other sources, interest paid on funds borrowed specifically to purchase shares in companies with no immediate prospect of earning income, e.g. speculative shares.

In such cases the interest paid can be capitalised to the cost of the shares, which cost will be able to be set-off against the proceeds of the sale of those shares if the taxpayer is a share dealer.

ISOLATED TRANSACTIONS

The fact that a transaction may be an isolated transaction does not cause it to be free of tax if the transaction was embarked upon with a view to profit-making.

ITC 509 (1941) 12 SATC 239

ITC 378 (1937) 9 SATC 336

Chennels vs. Commissioner of Taxes (SR) (1936) 8 SATC 181

CIR vs. Strathmore Exploration Ltd (1956) (1) SA 591 (A) 20 SATC at pages 385/6

ITC 173 (1930) 5 SATC 174, and

ITC 194 (1931) 5 SATC 373.

LIQUIDATION DIVIDENDS - NRST IMPLICATIONS

Liquidation dividends distributed by a company to any non-resident shareholders are subject to non-resident shareholders' tax only insofar as they represent profits, other than those of a capital nature earned prior to or during the liquidation.

LOAN RAISING FEES

In the case of a loan raised for the immediate purposes of a business (e.g. to finance stock in trade purposes), any expenditure incurred in obtaining such a loan is expenditure incurred in the production of income and is therefore allowable as a deduction from income - CIR vs. Genn & Company (Pty) Ltd (1955) (3) SA 293 (A), 20 SATC 113.

However, where a loan is raised for the purchase of fixed assets the interest on the loan will be allowed from the time that the asset produces income. Any commission or raising fee, however paid, is not allowable as a deduction from income. The same principle applies to the costs of raising a loan to pay off an existing loan which was originally raised for the acquisition of fixed assets.

Where the business of a taxpayer includes that of a money lender, in terms of Revenue department practice, the costs of raising funds for that purpose are deductible from income.

In ITC 882 (1959) 23 SATC 239 it was held that a loan raising fee in respect of a mortgage bond raised to enable a company to erect a rent-producing property, formed part of the capital expenditure of acquiring the property and therefore was not an allowable deduction under Section 11(a) of the Income Tax Act.

LOSSES - ARISING FROM EMBEZZLEMENT

In Lockie Brothers Ltd vs. CIR (1922) TPD 42, 32 SATC 150 the court held that a loss suffered by reason of theft or embezzlement of cash, stock-in-trade or other floating capital is not allowable for tax purposes.

A loss incurred by a firm of attorneys in making good an irrecoverable loan, which had been advanced out of funds entrusted to the firm for investment, was held to be deductible in ITC 815 (1955) 20 SATC 487 where the firm had been induced by fraudulent misrepresentations to make the loan. The court held that as the income of the firm was earned in part by the investment of clients' funds, the loss was incurred in the course of an operation directed to the production of income and that the risk of loss in the manner in which the loss was incurred was a necessary incident of the business carried on. In the same case the court dismissed the taxpayer's claims to deduct losses incurred as a result of defalcations by employees of the firm.

In ITC 184 (1930) 5 SATC 268, where an accountant's clerk embezzled a client's funds which the firm had then made good, the court followed the principle established in the case Lockie Brothers Ltd vs. CIR (1921) TPD 42, 32 SATC 150 and came to the conclusion that it is immaterial whether the funds embezzled are those of the employer or moneys held in trust. If the loss was not incurred in the production of income it was not deductible.

LOSSES - ARISING FROM GUARANTEES

In ITC 277 (1933) 7 SATC 244 it was held that a payment by a shareholder who is also the manager of a company, under a personal guarantee given in respect of the company's bank overdraft, cannot be regarded as expenditure incurred in earning his remuneration as manager and accordingly is not an allowable deduction.

In a number of Special Court cases it has been held that where a vendor of a business sold as a going concern guarantees the outstanding book debts, any payment made under such guarantee in respect of debts which prove to be irrecoverable is a capital loss and not an allowable deduction.

- ITC 449 (1939) 11 SATC 98
- ITC 466 (1940) 11 SATC 251

NRST - ROYALTIES

The receipt of royalties from South African sources by a company not registered not carrying on business in South Africa does not signify that the company itself is actually carrying on business in South Africa.

The provisions of Section 42 of the Income Tax Act are therefore held to apply and the company in receipt of the royalties is liable for non-resident shareholders' tax in respect of any dividends which may accrue to it from companies in South Africa.

OPTION MONIES

A taxpayer who derived income from the letting of owned immovable properties, received R400 as consideration for the grant of an option in terms of a contract which provided for the taxpayer undertaking to let certain premises at an agreed rental to the option holder if an when the existing tenant vacated the premises. The question as to whether the option moneys were taxable were decided in ITC 721 (1951) 17 SATC 485 where the Special Court dismissed the taxpayer's appeal, holding that the amount received was derived from the productive use of the capital invested in the property owned by the taxpayer in order to earn profits, and as the receipt had been derived in the course of the taxpayer's business, the amount constituted income and was not an accrual of a capital nature.

It was held in ITC 640 (1947) 15 SATC 229 that a profit derived from the disposal of an option to purchase a specific property, was made in the course of carrying out a scheme of profit-making and was, therefore, not of a capital nature. The facts of the case were that the taxpayer, a recently retired speculative builder who was engaged in farming, acquired the said option for a few week, and while investigating the subject of alterations and their financing, received an offer to purchase his option from a third party. The taxpayer accepted the offer and after deducting all his expenses he was left with a profit of R9124. The court considered the taxpayer's past activities as a speculative builder, and was unable to find that the taxpayer had shown that the probabilities were more in favour of the view that he had entered into the transaction solely for the purpose of making an investment. Accordingly the taxpayer had failed to discharge the onus placed upon him by Section 84 of the Income Tax Act. This case once again revolves around the taxpayer's onus to prove his intentions or his change of intentions.

ITC 118 (1928) 4 SATC 71 relates to a taxpayer who had been employed in an attorney's office. The taxpayer purchased options over certain land in the hope of the discovery of platinum in the area. Soon after acquisition the taxpayer disposed of his options at a profit which was subject to taxation.

The court, in dismissing his appeal, held that the taxpayer had acquired the options specifically with the intention to resell them at a profit in a scheme of profit-making. The profit was accordingly taxable notwithstanding that the transaction was an isolated transaction. A similar decision was given in ITC 120 (1928) 4 SATC 112 where a merchant participated with a prospector in acquiring and selling option rights over farms thought to contain platinum.

However, where the right to prospect is granted in pursuance by a landowner in an endeavour to dispose of a property or the mineral rights attaching thereto, any option moneys received by the owner of the property in respect of those rights represent an accrual of a capital nature which is not subject to taxation.

PRE-INCORPORATION PROFITS

Pre-incorporation profits generally fall into one of the following three broad groupings:

1. Where the vendor disposes of his assets in terms of an agreement which is given retrospective effect;

2. Where the agreement is effective from the date of the signature only; and

3. Where the agreement is effective from a date subsequent to the date on which it is entered into.

Pre-incorporation profits falling into category 1 above are taxable as follows:

a) For the period from the effective date of the agreement to the actual date thereof the profits are taxable in the hands of the vendor.

b) For the period from the actual date of the agreement to the date of incorporation of the company the profits are taxable in the hands of the agent in his capacity as trustee for the company to be formed.

Pre-incorporation profits falling into category 2 above are taxable as follows:

a) That portion of the pre-incorporation profits which relates to the period from the date of the agreement to the date of incorporation of the company is taxable in the hands of the agent in his capacity as trustee for the company to be formed.

In most cases category 3 above will create us difficulties as the company will have been formed by the time the agreement comes into effect. Where the formation of the company is delayed any pre-incorporation profits will be subject to tax in the hands of the agent in his capacity as trustee for the company to be formed.

Where the operations during the period from the actual agreement date to the date of incorporation result in a loss which is subsequently assumed by the company, neither the company nor the agent in his personal capacity is entitled to such loss for income tax purposes.

Where amounts are subject to tax in the hands of the agent of the company to be formed, the rate of tax to be applied is that applicable to unmarried persons.

RENT PAID - EXCLUSION OF COMPETITION

In ITC 682 (1949) 16 SATC 361 the concessionary of certain trading rights over a number of contiguous farms on which mining operations were in progress, carried on trading from stores erected on three of the farms but sought to deduct the rentals paid for the trading rights on all the farms over which the concessions extended. On appeal the court were of the opinion that the predominant reason for paying the rentals in respect of farms other than those where trading stores were erected was to exclude trade competitors. As money expended to eliminate competition is not wholly or exclusively applied for the purpose of trade, the expenditure was not deductible.

RENT PAYABLE - ABANDONED PREMISES OR TO PREVENT COMPETITION

Where rentals are paid by a taxpayer for premises in which an abandoned business has ceased to trade and from which no direct income accrues, such rentals are not allowable as a deductible expense. Similarly, rent paid for premises in order to prevent a competitor from trading from such premises is also not allowable as a deductible expense, the rent being for the purpose of protecting income and not in the production of income.

RESERVES

RESERVES FOR DISCOUNT

In ITC 563 (1944) 13 SATC 319 it was held that a reserve claimed for discounts, not in excess of the discount accrued and due to customers in respect of goods supplied, on outstanding accounts at the end of the year of assessment is deductible.

RESERVE FOR SERVICING

In ITC 183 (1930) 5 SATC 262 it was held that a claim for a deduction of a reserve created to meet the contingent liability of a garage which sold motor vehicles under agreements which provided for the replacement of defective parts and to provide free service in making adjustments for a specified period, was not deductible in terms of a section of the Act which was the forerunner of Section 23(e).

RESERVE FOR UNCOMPLETED CONTRACTS

In ITC 423 (1938) 10 SATC 335 a claim for the deduction of an amount transferred to a reserve to cover anticipate losses on uncompleted contracts for the regular supply to large customers of perishable goods at a predetermined price was held, on appeal, to be prohibited in terms of a section similar to the present Section 23(e). The goods were subject to reasonable price fluctuations which provided the taxpayer with profits in the first half of the year and losses in the second half of the year. The reserve had been intended to provide for the loss to be expected in the six months following the close of the tax year.

RESTRAINTS OF TRADE - A PART OF THE GOODWILL OF A BUSINESS

Owen Salmon (in his article titled "Restraints Of Trade -And The Goodwill Of A Business", on pages 243 and 244 of the 1989 volume 18 of Businessman's Law), states that:

> "In the Carapax Shadeports case, the Transvaal Provisional Division has reinforced the legal precept that a restraint against competition by ex-employees is an asset in a business which, at the same time, also contributes to the goodwill of that business. The sale of such goodwill consequently transfers the benefit of the restraint to the purchaser. What is, perhaps, equally significant is that restraints against ex-employees should be taken into account when assessing the value of a business at the time of its sale."

The Carapax Shadeports case referred to above is more fully described in Carapax Shadeports (Pty) Ltd vs. Both and Another (Case No. 5666/89) (TPD), which case was heard by the Honourable Mr Justice De Klerk who delivered judgement on 17 May 1989. This and several other recent Transvaal judgements, extrapolating from the 1982 Cape Provincial Division judgement in Protea Holdings Ltd vs. Hertzberg (1982 (4) SA 773 (C)), have held restraints of trade to be assets of a business and therefore part of its goodwill.

In the case of Venter, Moore and Stapelberg CC vs. Paulus Johannes Van Der Berg (an unreported TPD judgement - Case No. 20637/87 of 29 December 1987), Preiss, J, after referring at some length to the above-mentioned Protea Holdings Ltd case, stated:

> "In short, I have come to the conclusion that the restraint is part of the assets of the business and part of the goodwill, not only be definition in the agreement, but by the general meaning of the agreement and that goodwill was transferred successively until it ended up in the hands of the present applicant." - (At page 11, line 28 of the typed judgement).

SALARY ACCRUALS AND ARREARS

In ITC 854 (1958) 22 SATC 193 the salary of a municipal employee was upgraded and the increase backdated over the tax year in which the payment of the arrears was made, and also the two preceding years. On appeal it was held that the full amount of the arrears accrued and was subject to taxation in the year of assessment during which the conciliation agreement giving rise to the increase was signed.

In ITC 525 (1942) 12 SATC 424 the amount due to the taxpayer for services rendered over several arrear years was in dispute and finally agreed upon in a deed of settlement in which the amounts attributable to each of the years was agreed upon. On appeal, it was held, following the decision in CIR vs. Delfos (1933) AD 242, 6 SATC 92, that the total sum had rightly been taxed for the year in which it had been received by the appellant notwithstanding that, by the voluntary allocation made in the agreement of settlement, the different sums were appropriated ex post facto to previous periods.

SALARY ACCRUAL - PAYMENT IN LIEU OF NOTICE

In ITC 211 (1931) 6 SATC 61 the appellant in terms of his employment contract was entitled to six months' notice on termination of his services. On 1 June he was retired and paid six months' salary in lieu of notice to which he was entitled. During the tax year he now had eleven months' salary plus a further six months' salary in lieu of leave and notice, all of which was included in his taxable income for that year. In dismissing the taxpayer's appeal the court held that the offer of six months' pay in lieu of notice and its acceptance by the taxpayer terminated the employer's previous obligation and constituted a new obligation for the immediate payment of the sum in lieu of notice and that the appellant taxpayer both became entitled to and received the amount payable within the same year of assessment as he received his normal salary.

SALARY INCOME - SHARES IN LIEU OF

Where a contract of service fixing the rate of remuneration for an employee exists and shares are allotted in lieu of salary income, the shares must be taken at a value, whether in excess of their nominal value or not, equivalent to the contractual remuneration or such portion thereof which is not paid in cash, as the case may be, for the purpose of determining the employee's income.

Where there is no contract, but it is established that the shares allotted are value for services rendered, the company is required to place a value on the shares allotted for such services. Failing this, the nominal value of the shares allotted forms the basis of assessment.

Any surplus which may subsequently arise from the disposal of shares acquired in lieu of remuneration for services rendered will be of a capital nature unless it can be established that the recipient is a share dealer and the disposal of those shares was part of his dealing or carrying on a trade in shares - ITC 726 (1951) 18 SATC 90.

STOCK ON HAND

"Stock should be valued on a proper commercial basis, regardless of whether the basis coincides with that allowed for income tax purposes."

"Auditing" by Ronald A Irish
Second edition at page 214

"A secret reserve which is unwarranted by the facts should not be agreed to. The directors are entitled to be reasonably cautious in appraising stocks, but this does not justify a hidden and deliberately excessive reserve which is designed to reduce disclosed profits."

also at page 214

The objective of picking out these unusual or abnormal factors is not to just eliminate them altogether from profits, as to ensure that each year's profits bears its fair share of all that is unusual, and in particular that the profits of the latest years are not unduly distorted and the values of assets are not overstated or understated. Any resulting adjustment must also take into account the taxation effects thereof.

STOCK ON HAND - APPRECIATED VALUE

The appreciation in value of stock on hand is not income until the stock is disposed of by a realisation. Accordingly for valuation purposes a valuer should provide for this deferred tax liability on the difference between the current appreciated stock value and the original cost of the stock.

STOCK-IN-TRADE - LOSS ON DISPOSAL OF

Based on the judgement in CIR vs. J Niko (1940) AD 416, 11 SATC 124, losses incurred by a trader as a result of the disposal of his stock-in-trade are allowable as deductions in the computation of his taxable income, irrespective of whether the loss is occasioned as a result of normal trading activities or the disposal of stock in bulk on the closing down of a business.

STOCK-IN-TRADE - REMOVAL EXPENSES

The cost of removal of stock-in-trade, including livestock in the case of a person carrying on farming operations, is expenditure incurred in the production of income and allowable as a deduction.

Removal expenses in respect of other business assets is regarded to be of a capital nature.

TRAVELLING EXPENSES - DIRECTOR OF COMPANIES

A director of companies, the head offices of which are situated in different cities and towns, and who incurs travelling expenses in travelling from place to place to attend directors' meetings, is not entitled to deduct those travelling expenses from the fees received from his appointments, such expenditure being regarded as personal expenditure. This disallowance is based upon the judgement of the House of Lords in Re Ricketts vs. Colquhoun (42 LTR 66).

WEAR AND TEAR - MACHINERY SUBJECT TO USUFRUCT

The principles enunciated in the case of Geldenhuys vs. CIR (1947) (3) SA 256 (C), 14 SATC 419 provide authority for the view that a taxpayer is not entitled to an allowance for wear and tear in respect of machinery and plant which is subject to a usufruct in his favour.

Accordingly, it would appear that a usufructory should be taxed on the net income arising from a usufruct before the deduction of wear and tear. This appears to create an anomaly as the wear and tear which occurs would not be deductible, there being no other income to set it off against. Care should therefore be exercised in the wording of usufructs where wasting assets will be made use of, to ensure that the trust or bare dominium holders to whom the asset subject to wear and tear attaches, receive an adequate rental against which to set off the wear and tear, such rental being paid from the arising income prior to the determination of the amount of the usufruct from time to time.